

TAXATION OF PAYMENTS OF DAMAGES AND COMPENSATION**CONTENTS**

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1 INTRODUCTION

Receipts of damages and compensation may be assessable as ordinary income under Div 6 of the *Income Tax Assessment Act 1997* (ITAA97), or as statutory income. Such statutory income includes net capital gains under Chpt3 of the ITAA97, eligible termination payments (ETPs) or parts thereof (see Subdiv 2AA of PtIII of the *Income Tax Assessment Act 1936* (ITAA36)), receipts caught by s15-30 of the ITAA97 (insurance or indemnity for loss of assessable income), or s26(e) of the ITAA36 (allowances in relation to employment),¹ and assessable recoupments under Subdiv 20-A of Pt 2-1 of the ITAA97.

Of less general interest than these provisions, are other provisions in the ITAA97 and the ITAA36 dealing with the taxation of damages or compensation in particular circumstances. These have a comparatively limited application.²

In each case, it is necessary to consider what, if any exemption or concession may apply,³ and where a receipt may be assessable under more than one provision, the relevance of any anti-overlap provisions.

Payments of compensation may be deductible under Div8 (deductions) or s40-880 (capital expenditure) of the ITAA97, or under some provision having a more limited application,⁴ or they may form the cost base or part of the cost base of a CGT asset.

In this paper, I am going to concentrate on two questions of general interest: the question of when receipts should be categorized as ordinary income or as capital gains; and the question of when there is a case for adjusting the amount of compensation or damages to take into account a potential liability to tax. I will finish with some comments on GST, on the drawing of claims and settlement agreements, and on the conduct of cases where some such adjustment may be called for.

For the most part, where provisions in the ITAA97 correspond with provisions in the ITAA36, I shall refer only to those in the ITAA97.

2 THE RELEVANCE OF TAXATION TO THE ASSESSMENT OF DAMAGES⁵

A fundamental principle for the assessment of damages, is that the tribunal should award the injured party such sum as will put the party in the same position it would have been in had the party not sustained the injury.⁶ Another principle with which this fundamental principle sometimes comes into conflict, is that damages are assessed once and for all by reference to the probabilities proved by the relevant evidence.⁷ The assessment of damages is subject to various limiting factors such as remoteness and the duty to mitigate. Damages can be awarded for the loss of an opportunity or chance,⁸ and for exposure to a risk of loss.

From these principles, we can deduce the following rules applying to the relevance of taxation to the assessment of damages.⁹

Rule 1: Where taking into account the award of damages or compensation, the defendant's wrongful conduct does not affect, ie, increase, reduce, hasten or delay the incidence of tax borne by the plaintiff, the taxation of damages is irrelevant to the assessment of damages.¹⁰ Thus, no adjustment to the amount of compensation or damages because of a potential liability tax ('taxation adjustment') is called for where

¹ This is not an exhaustive list or anything like it of statutory income.

² Eg, ITAA36, s26AG(4); ITAA97, s15-25, 70-55, Subdiv20-A of Chpt2.

³ For example, there are exemptions applying to CGT in Div 118 (see especially, s118-37) and in Pt 3-3 of the ITAA97.

⁴ Eg, ITAA97, ss25-15 and 25-50.

⁵ For a more detailed discussion of this topic as it affects CGT, see the author's article, 'The Impact of Capital Gains Tax on Damages,' (2002) 31 Aust Tax Rev 233.

⁶ See *Cullen v Trappell* (1980) 146 CLR 1, 11. See also *Haines v Bendall* 172 CLR 60, 63.

⁷ See *Osrlic Investments Pty Ltd v Woburn* [2001] FCA 1402 and cases therein referred to.

⁸ See *Commonwealth v Amann Aviation Pty Ltd* (1991) 174 CLR 64.

⁹ On this subject, see Slater QC and Durack SC, 'Taxation of Judgments, Awards and Settlements', NSW Bar Assoc, CLE Program, 9 October, 1995.

¹⁰ See, eg, *Spencer v Macmillans Trustees* [1959] SLT 41.

neither the damages nor what is being compensated for would be assessable (or taxable), or where a statutory right to compensation is to a net after tax amount.¹¹

Rule 2: Where the defendant's wrongful conduct does have such an effect (ie, it alters the incidence of tax), subject to considerations of remoteness, the altered incidence of taxation is relevant to the assessment of damages.¹² Its incidence may provide an additional head of loss.¹³ Or its incidence may furnish a ground of reduction, because the lost income would have been taxed but the damages will not be.¹⁴ This principle is sometimes referred to as the 'Gourley' principle¹⁵ and has a number of results. For example, where an award of damages includes compensation for loss of income which would have been taxable, and the damages are not taxable, the damages must be computed by reference to the net loss of income after allowing for the tax which would have been paid.¹⁶ Thus in *Cullen v Trappell*,¹⁷ the incidence of income tax on the income that the plaintiff would have earned (but for the defendant's wrongful act) was relevant to the assessment of damages for loss of earning capacity and had the effect of reducing those damages. This was so, even though what was being compensated for was not, in strictness, the loss of income, but rather, the loss of capacity to earn income. Again, it has been said that there is a case for saying that an award should be loaded to cover the excess tax resulting from the money being paid in one taxation year instead of being spread over the period of the loss.¹⁸

Rule 3: In order to determine whether or not the defendant's conduct does have an effect on the plaintiff's liability to tax, it is necessary to work out what tax the plaintiff would have paid but for the defendant's conduct, and what tax the plaintiff will pay on the damages. Because of the complexity of taxation provisions and the way in which they operate, this can be difficult.

A further difficulty is lack of certainty about the course of future events. In assessing compensation, questions may arise, for example of the likelihood of a plaintiff company's going into liquidation some time in the future, of its making losses, or of possible changes in rates of tax, or – rare as it is – the abolition of a tax.¹⁹ In many cases, it is difficult to say what the incidence of taxation would have been if the occasion for the plaintiff's claim not happened.

One possible solution to such difficulties is to say that the onus of proof of loss whether past, present or prospective, being on the plaintiff, anything he does not prove as being more likely than not, should be disregarded as being too speculative. Such a rule could, however, operate unfairly. Another solution, is to say that the plaintiff need not prove that something is more likely than not to happen, but only that there is a possibility of its happening, and to prove that possibility with the requisite degree of certainty. Damages are then reduced so as to reflect the degree of the possibility. There is some support for both approaches.²⁰

In many instances, the principles regarding the recoverability of damages, for example, in the case of contracts and torts, the rules as to remoteness, provide some certainty.²¹ Perhaps the best that can be done is to aim at some rough approximation to fairness.²²

I now turn to one of the factors in the equation for making tax adjustments: the question of how receipts of damages or compensation fall to be assessed.

¹¹ See, for example, *Accident Compensation Act* 1985 (Vic), ss134AB (3), (14), (32) and (34) and 135C(3).

¹² See, eg, *Saul v Menon* [1980] 2 NSWLR 314.

¹³ See *Fox v Wood* (1981) 148 CLR 438; *New South Wales Cancer Council v Sarfaty* (1992) 28 NSWLR 68, 79 to 80 and 97. Cf *Wheeler v Phillip Morris Ltd* (1989) 97 ALR 282.

¹⁴ See *Cullen v Trappell*, supra. In Victoria, the rule is now enshrined by statute in cases where damages are claimed for deprivation or impairment of earning capacity, see s28A, *Wrongs Act* 1958 (Vic), and generally on personal injury damages, see PtVB thereof.

¹⁵ So named after the seminal case, *British Transport Commission v Gourley* [1956] AC 185.

¹⁶ See *Lonie v Perugini & Perugini* 77 ATC 4318; *Melbourne Saw Manufacturing Co Pty Ltd v MMBW* [1970] VR 394, 398; *Robert v Collier's Bulk Liquid Transport* [1959] VR 280. See also fnn12 and 13.

¹⁷ Ibid.

¹⁸ See *Lonie v Perugini & Perugini* 77 ATC 4318, 4324. Note, however, ITAA36, Pt III, Subdiv 17AB (rebate for certain lump sum payments in arrears.)

¹⁹ It has been held that possible changes in rates of tax are to be ignored if purely speculative: see *British Transport Commission v Gourley* [1956] AC 185, 209; *Whiteman and Wheatcroft on Income Tax and Surtax* (1971) [20-15.]

²⁰ See comments on damages for loss of opportunity or chance above and section on running cases below.

²¹ See, for example, *Pennant Hills Restaurants v Barrell Insurances* 78 ATC at 4036ff; *Williamson v Cmr for Rlways* (1959) 76 WN(NSW) 648.

²² See *Barrell Insurances v Pennant Hills Restaurants* (1979) 145 CLR 625; *Gill v Australian Wheat Board* [1980] 2 NSWLR 355. In this case, Rogers J held that the whole essence of the decision in *Cullen v Trappell* (1980) 146 CLR 1 is that the reality of the impact of taxation must be recognized and allowed for, but that the plaintiff's ability to juggle his tax position should not be taken into account.

3 TAXATION OF DAMAGES OR COMPENSATION UNDER INCOME TAX LAWS

3.1 Practical consequences of characterisation of receipt as ordinary income or as capital gain

There are certain concessions and advantages pertaining to the characterization of amounts as capital gains rather than as ordinary income. For example, where the taxpayer is an individual, trustee, or the trustee of a superannuation fund, or small business active assets are involved, the capital gain remaining after the application of any capital losses and net capital losses from previous income years is reduced by a substantial discount (50% in the case of individuals) when working out net capital gains.²³ In effect this can substantially reduce the rate of tax.²⁴ Alternatively, if a CGT asset was acquired on or before 21 September, 1999, indexation of its cost base may be available.²⁵ In either case, to get the discount or indexation, the entity making the gain must have acquired the asset at least a year before the CGT event causing the gain.²⁶ If the relevant asset was acquired before 20 September, 1985, there may be an exemption from CGT.²⁷

Capital losses worked out for CGT events and net capital losses can be deducted only from capital gains, not assessable income.²⁸ But business capital expenditure not otherwise taken into account may be deductible under the black hole expenditure provisions (see below.)

3.2 Income or capital receipt?

How do you tell whether damages are to be categorized as ordinary income or as capital gains? The answer depends on the character of the receipt in the hands of the plaintiff.²⁹ In general, one asks, For what were the damages paid? This can be referred to as the quid pro quo, replacement or hole principle.³⁰ Were they paid for something on capital account, or for something pertaining to income, eg, loss of profits or lost wages? If the damages were paid for something pertaining to income according to ordinary concepts, s6-5 of the ITAA97 will apply.³¹ In some cases, the quid pro quo, replacement or hole principle is overridden by other considerations. For example, the damages or compensation may arguably constitute income because it is received in a series of recurrent, periodic payments that do not constitute instalments of a lump sum. (Indeed, the damages or compensation may be received in such form that the provisions regarding royalties and annuities apply.) Compensation for loss of earning capacity (an affair of capital) may be income if the payment is periodic and is intended to be a supplement to the payee's income.³² A policy of insurance against impairment of the fruit bearing capacity of a tree may well take the form of providing fruit (income) till the tree recovers its proper role.³³ If so, that fruit (compensation under the policy) will be income.

The fact that the amount of damages or compensation is payable in a lump sum is usually not a decisive factor in favour of its being capital,³⁴ but is not wholly without relevance.³⁵

One determines the question for what the damages were paid by having regard to the matrix of relevant facts.³⁶ In most civil litigation, those facts will appear from the determination of the Tribunal (and if necessary its reasons). It may also be necessary and relevant to look at the pleadings (if they truly delineate the issues) to see what the plaintiff was claiming damages for, the evidence, and any agreements between the parties relevant to the conduct or settlement of the litigation.³⁷ From this matrix

²³ See Div 115.

²⁴ Under the Rating Acts, in general, the rate does not differ depending on whether a receipt is ordinary income or capital gains.

²⁵ See Div 114.

²⁶ See Divs 115-25 and 114-10.

²⁷ See above.

²⁸ See ss100-50, 102-5 and 102-15.

²⁹ See *FCT v Smith* (1980) 147 CLR 578; *Carapark Holdings Ltd v FCT* (1967) 115 CLR 653, 660; *FCT v Slaven* (1984) 15 ATR 242, 252; *Sommer v FCT* 2002 ATC 4815; *Rajah's Commercial College v Gian Singh & Co Ltd* [1977] AC 312, 319.

³⁰ See *FCT v Slaven*, supra; *Carapark Holdings Ltd v FCT* (1967) 115 CLR 653; *FCT v Wade* (1951) 84 CLR 105; *Dickenson v FCT* (1958) 98 CLR 460.

³¹ Thus, for example, worker's compensation may be taxed as ordinary income: see Tax Determination TD 14.

³² See *FCT v Inkster* 89 ATC 5142.

³³ See *FCT v Smith* 81 ATC 4114.

³⁴ See *Sommer v FCT* 2002 ATC 4815; *CT v Myer Emporium* (1986) 163 CLR 199; *Van den Berghs Ltd v Clark* [1935] AC at 442.

³⁵ See *FCT v Dixon* (1953) 86 CLR 540, 556; *FCT v Harris* 80 ATC 4238, 4247 to 4248 per Fisher J.

³⁶ See, eg, *FCT v CSR* (2000) 104 FCR 44.

³⁷ *Ibid.*

of facts, one has to identify for what the damages were paid and then to categorize the damages as ordinary income, capital, or as falling within some other item of or exemption from assessable income.

The way in which you formulate your claim and the terms of any settlement, in addition to other circumstances such as the conduct of negotiations (eg, the content of a letter of demand), may affect the characterization of a receipt of damages or compensation as ordinary income or as one of the various types of statutory income, such as net capital gains. As we have seen, this in turn may affect the incidence of tax. Careful and considered analysis and drafting are therefore called for, in cases where a characterisation one way or another will affect the outcome.

The circumstances in which damages or compensation are properly categorized as being income or capital are almost as multifarious as the circumstances in which any kind of receipt can be categorized as income or capital, and it would be beyond the scope of this paper, assuming it were possible, to attempt an exhaustive catalogue of such circumstances.³⁸

A few examples will suffice. If, compensation is paid for the loss of a business or undertaking, or for the loss of the basis or foundation of trading activities, the compensation will generally be for loss of a capital asset, and hence in the absence of countervailing considerations, itself a receipt of capital; but if what was given up was something less, the receipt will more likely be one of income.³⁹ Damages for the cancellation of an agency or a service agreement is capital if the agency or agreement was the whole business of the taxpayer.⁴⁰ The fact that a receipt is compensation for the sterilization of a capital asset, eg, for a restrictive covenant, points towards its being a receipt of capital.⁴¹ Sums of money paid by way of damages, compensation or indemnity for a loss of profit incurred in the course of carrying on an enterprise or undertaking may, no doubt, be considered income, because they are part of the profits derived from carrying on the business, although they are occasioned by unusual or exceptional circumstances or events.⁴² Nevertheless, it is important not to confuse the measure of compensation with its character; so, for example, the value of a capital asset and hence compensation for its loss, may be measured by the profits which it generated.⁴³

In some cases, the characterization of compensation as income or as capital may turn on fine distinctions. For example, compensation for loss of wages is generally income whereas compensation for loss of earning capacity is capital. In one case,⁴⁴ a distinction was drawn between damages in the nature of hire of a vessel which might have been earning hire otherwise (ie, but for its not returning to port on time), and damages for the want of a vessel which might have been earning hire (eg, because it was destroyed.)⁴⁵

Where the damages or compensation are received pursuant to a statutory entitlement, for example under the *Accident Compensation Act 1985* (Vic), the question what the entitlement is for is generally answered by looking to the purpose for which entitlement arises. The purpose of a statutory payment, as disclosed by the terms of the statute itself, must be a powerful, though not conclusive aid to the determination of the payment.⁴⁶ Sometimes the statute itself will tell you what the payment is for; examples can be found in the *Accident Compensation Act 1985*.⁴⁷

In *Tinkler v FCT* 79 ATC 4641, Brennan J⁴⁸ said⁴⁹ that the character of a statutory payment depends upon the purpose of the payment as revealed by the statute, and the circumstances of its receipt by the taxpayer. The conditions of eligibility created by the statute and the statutory formula for its quantification provide the clearest definition of the purpose of a payment, though a purpose otherwise expressed in the statute is a useful, if subsidiary, aid to ascertaining the character of a payment made pursuant to its terms.

³⁸ A more extensive analysis of the caselaw on this subject is contained in 'Taxation of Compensatory Payments and Judgments' by Pincus QC (as he then was), (1979) 53 ALJ 365.

³⁹ See *CT (Vic) v Phillips* (1936) 55 CLR 144, 157.

⁴⁰ See *Van den Berghs v Clarke* [1935] AC 431; *Wiseburgh v Domville (Inspector of Taxes)* [1956] 1 WLR 312, 320 ('an enduring capital asset.'). See also, *Du Cros v Ryall* (1935) 19 TC 444 and *Scott v Cmr of T* (1935) 35 SR(NSW) 215.

⁴¹ See *Dickenson v FCT* (1957) 98 CLR 460.

⁴² *Californian Oil Products Ltd v Federal Commissioner of Taxation* (1934) 52 CLR 28, 46.

⁴³ See *Glenboig Union Fireclay Co Ltd v CIR* (1922) 12 TC 427. See also *Van den Berghs Ltd v Clark* [1934] AC 431, 442; *Cmr of T (Vic) v Phillips* (1936) 55 CLR 144, 156; *Californian Oil Products Ltd v FCT* (1934) 52 CLR 28, 46, 49, 51; *Cullen v Trappell* (1979-80) 146 CLR 1 per Barwick CJ and Aikin J (both in dissent but not on this point); *FCT v Northumberland Development Co Pty Ltd* 95 ATC 4483, 4492, 4495.

⁴⁴ *Burmah Steam Ship Co Ltd v Commissioners of Inland Revenue* (1930) 16 TC 67, 73.

⁴⁵ See also the judgment of Walsh J in *Williamson v Cmr for Rlways* (1959) 76 WN (NSW) 648.

⁴⁶ See *FCT v Slaven* 84 ATC 4077.

⁴⁷ See eg, s119G thereof.

⁴⁸ As he then was, a member of the Full Federal Court.

⁴⁹ At 4643.

In general, insurance moneys are to be considered as received on revenue account where the purpose of the insurance was to fill the place of a revenue receipt which the event insured against has prevented from arising, or of any outgoing which has been incurred on revenue account in consequence of the event insured against, whether as a legal liability or as a gratuitous payment actuated only by considerations of morality or expediency.⁵⁰

Because losses or outgoings are not deductible under s8-1 of the ITAA97 (general deductions) if of capital, or of a capital nature,⁵¹ it follows that receipts of compensation for losses and outgoings which are deductible under s8-1 will themselves generally be ordinary income.⁵² See also, ITAA97, ss20-20, 20-35 and 20-40 (recoupments.)

In summary of the foregoing: in determining whether the receipt will be ordinary income or not, you must always ask the question what is it for, is it a substitute for income or capital? If it is for income, it generally is ordinary income, and if for capital, in general it is capital. Having answered that question, you must ask whether there are any distinguishing characteristics, such as periodicity, regularity, or recurrence, which make the damages or compensation income or capital notwithstanding.

3.3 Apportionment of receipts

Another principle of importance, is that in a proper case,⁵³ a single receipt of a mixed capital and income nature may be apportioned between capital and ordinary income respectively. Such a receipt cannot, however, be thus apportioned, where the payment is in respect of a claim or claims for unliquidated damages only and is made under a compromise which treats it as a single, undissected amount of damages.⁵⁴ This principle has been much criticised by many commentators, though some of that criticism is misplaced. Particularly before the introduction of CGT, it was an unfortunate rule from the Commissioner's point of view.

Where the receipt is a lump sum which includes unliquidated damages, the question is whether, from the matrix of surrounding facts, there is any basis for apportionment.⁵⁵

Sometimes it is advantageous to the taxpayer if the damages can be apportioned.

In 1979, Pincus QC (as he then was) wrote that the difficulty about apportionment provides an incentive to litigants to settle their differences. Since the introduction of CGT, that statement requires qualification.

In the first place, the Commissioner will treat a receipt which cannot be dissected into components of income and capital as capital proceeds, this in some cases leading to a worse result for the taxpayer than if the receipt were apportionable.⁵⁶

Secondly, in general, the Commissioner will not allow you to claim the benefit of an exemption if it could apply to part only of an award of damages, but the damages cannot relevantly be apportioned. In such cases, obviously, it may be in the plaintiff's interests that the court order or deed of settlement apportion the damages so that there is an entitlement to the exemption from taxation. This is likely to be of potential benefit to both parties, so it should not be difficult to get the other side to agree.

In other cases, if for example, part of the damages consist of an amount to which a higher rate of tax would apply if it were segregated, it may be better if the amount is not apportionable. This result may be achieved, eg, because the defendant merely makes an 'all in' offer to settle a claim both for income and capital losses which the plaintiff accepts. One has always to be aware of the looming presence of Pt IVA,

⁵⁰ See *Carapark holdings Ltd v FCT* (1966) 115 CLR 653, 663.

⁵¹ See s8-1(2).

⁵² See fn42.

⁵³ It would appear that compensation can be treated as having been paid only for claims which are at least arguable: see *Allsop v FCT* (1965) 113 CLR 341, 352 cf 351.

⁵⁴ See *McLaurin v FCT* (1961) 104 CLR 381; *Allsop v FCT* (1965) 113 CLR 341; *Sommer v FCT* [2002] ATC 4815. This principle is not to be confused with various statutory provisions for apportionment, which may apply to various kinds of statutory income; see, eg, ITAA36, s27A(1)(n).

⁵⁵ See *FCT v CSR* (2000) 104 FCR 44; *Sommer v FCT*, supra; *Case W 40 89* ATC 399; *Easy v FCT* (1941) 6 ATD 101. For a recent case, see *McNally v FCT* 2006 ATC 2270 (AAT.)

⁵⁶ See Section below on *Taxation of damages which are capital*, Guidelines 4 and 5.

however. It may be advantageous to accept an unapportionable sum because as such it will be subject to a lower rate of tax than would otherwise be the case; eg, if it is an ETP.⁵⁷

If the receipt is assessable as net capital gains rather than as ordinary income, different rules apply. Under s116-40, if you receive a payment in connection with a transaction that relates to more than one CGT event, or one CGT event and something else, the capital proceeds must be reasonably apportioned.⁵⁸

Note also, ITAA36, s262 (periodical payments in the nature of income.)

3.4 Costs

The proceeds of an order for costs, where not ordinary income, may be assessable under Subdiv 20-A of Pt 2-1 of the ITAA97 as the assessable recoupment of a deductible expense.

3.5 Interest

Post-judgment interest is in the nature of interest and is derived as ordinary income.⁵⁹ Post-judgment interest received on damages for personal injuries is, however, subject to certain conditions, exempt income.⁶⁰

Pre-judgment interest can presents problems of characterization. It is not taxable as ordinary income if awarded under the *Supreme Court Act 1986 (Vic)* or *Federal Court of Australia Act 1976* on unliquidated damages that are capital, such as damages for loss of earning capacity.⁶¹ It is regarded as being part of those damages and hence capital. The reasoning which leads to this result is contrary to the English authorities, which hold that pre-judgment interest under comparable statutory provisions, is in the nature of interest.⁶²

Interest is ordinary income where it is compensation for lost earnings, such as where, had the plaintiff not suffered damages, he would have earned the interest awarded.⁶³

But in many cases and arguably in all cases, this will not be the purpose of an award of pre-judgment interest pursuant to statute⁶⁴ and depending on the circumstances it may or may not be the purpose of an award at common law.⁶⁵

Interest is also ordinary income if, like post-judgment interest it is payable on a sum, which, in respect of the period over which it is computed, was ascertainable and due.⁶⁶ In such cases, it may be or be analogous to the product of a principal sum, and as such, analogous to the fruit of the tree.

So-called interest is not always in the nature of interest.⁶⁷ For example, the Commissioner says that whether a part of compensation is in the nature of interest is a question of fact,⁶⁸ and that penalty interest paid for the premature repayment of a loan is not in the nature of interest and is a capital sum.⁶⁹

3.5.1 Taxation adjustments and pre-judgment interest

As we have seen, pre-judgment interest awarded under the *Supreme Court Act 1986 (Vic)* or *Federal Court of Australia Act 1976* on unliquidated damages for personal injuries that are capital, including damages for loss of earning capacity is not taxable.⁷⁰ In such cases, it does not follow, however, that the award of interest should be reduced because it is tax free. Arguably, it should only be reduced if it were

⁵⁷ See ITAA97, ss118-20 and 118-22, ITAA36, s27Aff and *McNally v FCT* 2006 ATC 2270 (AAT.)

⁵⁸ As to apportionment of the cost base, see s112-30.

⁵⁹ See *Whitaker v FCT* (1998) 98 ATC 4285.

⁶⁰ See s51-55.

⁶¹ See *Whitaker v FCT* (1998) 98 ATC 4285.

⁶² See *Riches v Westminster Bank Ltd* [1947] AC 390.

⁶³ See *Federal Wharf Co v DFCT* (1930) 44 CLR 24. See also, *FCT v Blake* 84 ATC 4661 and cf *FCT v Harris* 80 ATC 4238.

⁶⁴ See *Haines v Bendall* (1991) 172 CLR 60, 66.

⁶⁵ See *Hungerfords v Walker* (1988) 171 CLR 125, 152.

⁶⁶ See *Whitaker's case* above and *Northumberland Development Co Pty Ltd v FCT* 95 ATC 4483.

⁶⁷ *Ibid.*

⁶⁸ See TR95/35 at para 246.

⁶⁹ See TR93/7.

⁷⁰ See *Whitaker v FCT* (1998) 98 ATC 4285. Interest under s134 AB (34) of the *Accident Compensation Act 1985* probably falls into the same category.

compensation for income on which the plaintiff would have been taxed. But it is not. It is awarded regardless of whether or not the plaintiff would have earned interest or otherwise received additional income. It is awarded simply as damages for delay.⁷¹

3.6 Taxation of damages under CGT provisions

It is important to remember that a capital gain as defined in ITAA97 can be reduced or disregarded under the anti-overlap provisions in Subdiv 118-A (General exemptions.)

There have been a few cases, not always easy to reconcile, on the application of the CGT provisions to receipts of damages and compensation, and on what adjustments (if any) to the amount of an award are called for in consequence.⁷² In addition, the Commissioner has published a number of public rulings on the taxation of damages under the CGT provisions; namely, TR 95/35 (capital gains: treatment of compensation receipts), TR 97/3 (capital gains: compensation received by landowners from public authorities), TR 99/19 (capital gains: treatment of forfeited deposits, instalments and damages), and TR 94/29 (CGT consequences of a contract for the sale of land falling through.) These are binding on the Commissioner until withdrawn.⁷³ They are not binding on taxpayers. From the rulings, it is possible to deduce a number of guidelines as to how the Commissioner will apply the CGT provisions to receipts of damages and compensation of various kinds, and what adjustments (if any) to the amount of damages or compensation may be called for in consequence.

The following are the main general rules or guidelines.

Rule: personal wrongs

A capital gain you make from a CGT event relating directly to compensation or damages you receive for any wrong or injury you suffer in your occupation, or for any wrong, injury or illness you or your relative suffers personally, is disregarded.⁷⁴ The Commissioner interprets illness as including psychological damage or mental injury.⁷⁵ He has ruled that 'you' is limited to natural persons, and that 'wrong' covers defamation, breach of privacy, sexual harassment, professional negligence of a solicitor in failing to institute a personal injury claim, unlawful discrimination and wrongful dismissal.⁷⁶ In some of these cases, the plaintiff can take a tax exempt annuity (called a personal injury annuity) rather than a lump sum by way of compensation.⁷⁷

It follows from the rule that the capital gain is disregarded, that CGT on the damages will be reduced to the extent to which the damages can be apportioned to damages received for wrong, injury or illness within the section. For examples, see Egs 14 to 17 of TR95/35. Whether this would call for a taxation adjustment to be made to the amount of damages, would depend on the circumstances.

Obviously, great care is required to ensure that the order or judgment for damages or the settlement deed or agreement are in such terms as to enable such apportionment as will allow the plaintiff to claim the benefit of the exemption.

Guideline 1: where disposal of underlying asset

The Commissioner treats⁷⁸ the receipt of damages for the disposal of an asset by the plaintiff as capital proceeds. The damages are treated as capital proceeds of the disposal albeit in a less direct sense than payment of the purchase price. This approach is called the underlying asset or look through approach.⁷⁹ It is consistent with the reasoning in *FCT v Guy*.⁸⁰ Depending on the circumstances, the relevant CGT

⁷¹ Ibid and see cases referred to therein and see reference to *Haines v Bendall* above.

⁷² See below.

⁷³ See TR 92/1 and Sch1 to the *Taxation Administration Act 1953*.

⁷⁴ See s118-37(1).

⁷⁵ See Draft Tax Ruling (DTR) 1999/D1.

⁷⁶ See TR 95/35.

⁷⁷ See Div 54 of the ITAA97.

⁷⁸ See TR 95/35.

⁷⁹ Ibid. The Commissioner justifies this approach by reference, inter alia, to s118-30 (insurance policies) and Subdiv 124-B: see TR 95/35 [70ff] and *Carborundum Realty Pty Ltd v RAI A Archicentre Pty Ltd* (1993) 25 ATR 192.

⁸⁰ 96 ATC 4520, 4531 (Full Federal Court.) Cf *Brooks & Anor v FCT* 2000 ATC 4362 (FFC), not following *Guy's* case on one, but not this point.

event⁸¹ may be A1 (disposal of a CGT asset), or C1 (loss or destruction of a CGT asset), in which case there may be a roll-over of the capital gain so that it is reduced or disregarded.⁸²

Where this guideline applies, a capital gain made from the disposal of a taxpayer's main residence or car may be exempt,⁸³ and a capital gain is generally disregarded where the plaintiff acquired the asset before 20 September 1985.⁸⁴

This guideline applies to such cases as a plaintiff suing his agent for causing the plaintiff to sell an asset for less than it was worth,⁸⁵ and compensation paid for a compulsory acquisition.⁸⁶

Without particular facts, it is difficult, indeed dangerous to generalize about the need for tax adjustments in a particular category of case. Nevertheless, it seems safe to say that there should be no cause for making an adjustment to the damages on account of CGT, where the proceeds lead to the same CGT consequences whether paid as purchase moneys or as damages.⁸⁷ So far as I can tell, in many, if not all cases, this will be the position.

Guideline 2: where underlying asset not disposed of but permanently damaged or reduced in value

If there is no disposal of an underlying post CGT asset at the time of receipt of the damages, but the damages are awarded for its being permanently damaged or reduced in value, the Commissioner treats the receipt of damages as a recoupment of expenditure made on the asset, thus reducing its cost base.⁸⁸ It is as if the cost which the plaintiff has recouped was never incurred; hence, for example, only the adjusted cost base can be subject to indexation.⁸⁹ There are no CGT consequences until the underlying asset is disposed of, or is the subject of some other CGT event; moreover, to the extent that the damages exceed (if at all) the unindexed cost base of the underlying asset, there are no CGT consequences.⁹⁰

Examples are as follows: compensation for damage caused to the plaintiff's building by the defendant's negligent operation of machinery;⁹¹ compensation for permanent damage caused to the plaintiff's goodwill by reason of defamation by the defendant.

The recoupment⁹² has to be a recoupment of expenditure.⁹³ A recoupment includes an indemnity.⁹⁴ According to the Commissioner, where a plaintiff gets damages for the actual or anticipated cost of repairing permanent damage to an underlying asset, but the plaintiff chooses not to incur the expenditure on the underlying asset for which he has been compensated, there is no recoupment, and the right to seek compensation is the most relevant asset in respect of which the damages have been received.⁹⁵

In most, if not all of these types of cases, it seems likely that a tax adjustment would not be warranted, except in certain circumstances where the damages were in excess of the unindexed cost base of the underlying asset. Where as a result of the damage caused to the underlying asset it is later sold for less than it otherwise would have been, the shortfall in the capital proceeds may correspond with the reduction in the cost base that is due to the recoupment. If the damages pay for repairs so that there is no shortfall in capital proceeds, then the plaintiff will be in the same position he would have been in had he not suffered the loss.⁹⁶

⁸¹ As to which, see s104-5.

⁸² See, eg, Subdiv 124-B of the ITAA97.

⁸³ See s118-5 and Subdiv 118-B and *Guy's* case, *supra*.

⁸⁴ See ss104-10(5) (special rule for leases) and s104-20(4), but subject to special requirements where corporate taxpayers, see eg, Div 165 and generally, TR 95/35.

⁸⁵ See, as an example, the facts in *Provan v HCL Real Estate* 92 ATC 4644.

⁸⁶ See TR 95/35, but note also the roll-over provisions in Subdiv 124-B of the ITAA97.

⁸⁷ See *Carborundum Realty Pty Ltd v RAI Archicentre Pty Ltd* (1993) 25 ATR 192; *Namol Pty Ltd v AW Baulderstone Pty Ltd* (1993) 27 ATR 181; *Joondalup Gate Pty Ltd v Minister for Lands (WA)* (1996) 33 ATR 327; cf *Rabelais Pty Ltd v Cameron* 95 ATC 4552.

⁸⁸ See TR95/35 and Eg 6 therein.

⁸⁹ See TR 95/35 at [130].

⁹⁰ See TR 95/35.

⁹¹ See TR 95/35, Eg 6.

⁹² As to what is a recoupment, see s20-25.

⁹³ See ss110-45(3) and 110-55(6).

⁹⁴ See s20-25.

⁹⁵ See TR 95/35 at [135 to 137]. Query whether this needs to be re-examined in light of the definition of 'recoupment' in the ITAA97 referred to above. The ruling analyses the CGT provisions in the ITAA36, which have been replaced by the CGT provisions referred to above.

⁹⁶ If the cost of the repairs is deductible, then their recoupment will in general be assessable.

Guideline 3: the plaintiff receives damages for paying an excessive price for an asset

In this case, the Commissioner treats the damages as being a recoupment of the cost base, as under the last preceding guideline. An example of this case, would be a purchaser receiving such damages by reason of his agent's having colluded with the vendor, or having failed to detect defects in the property, as in *Carborundum Realty Pty Ltd v RAlA Archicentre Pty Ltd*.⁹⁷ Another example is furnished by the facts in *Duke Group (in liq) v Pilmer*⁹⁸ (excessive price paid for shares.) See also Egs 5, 20 and 24 in TR 95/35.

Assume A paid \$x too much for an asset and gets damages of \$x. A sells the asset. Assume further had A not paid \$x, his profit on sale (ignoring the damages) would have been greater by \$x. In such a case, because the capital gain is the same as it would have been if A had not paid \$x, no taxation adjustment in assessing the damages is called for.

Guideline 4: where no underlying asset of relevance

This is different from the previous cases discussed. In this category of case, the Commissioner treats damages as being capital proceeds for the release, discharge or satisfaction of the cause of action within the meaning of CGT event C2.⁹⁹ The Commissioner says that the relevant causes of action are acquired at the time of the first actionable wrong.¹⁰⁰

There are significant limitations on the elements of the cost base of the cause of action.¹⁰¹ Although in *Namol Pty Ltd v AW Baulderstone Pty Ltd*,¹⁰² the Court said that loss suffered could be considered as being part of the cost base, in the opinion of the writer, it is difficult to see any warrant for that conclusion in the cost base provisions themselves, and it is unlikely that the Commissioner would accept this view. Nevertheless, the Commissioner says that expenditure incurred by a plaintiff and claimed as a head of damages, are treated as part of the cost base, and likewise, compensation paid by a plaintiff for which he claims an indemnity from his insurer, is part of the cost base of the claim to be indemnified by the insurer.¹⁰³ The Commissioner also treats the plaintiff's legal fees and charges as being part of the cost base.¹⁰⁴

There is some support in the authorities for treating the cause of action as the relevant asset in a wider category of cases than that to which it is applied by the Commissioner.¹⁰⁵ Assuming the treatment has the more limited application, the following examples of cases where it would apply may be given: the plaintiff vendor receives damages by reason that a contract for the sale of land has fallen through in circumstances where there is no associated disposal of the land;¹⁰⁶ the plaintiff receives damages for breach of a covenant not to compete with the plaintiff's business.¹⁰⁷

In such cases, as in *Duke's case*¹⁰⁸ and Egs 8, 9 and 11 of TR 95/31, there may be a need for a taxation adjustment to be made when assessing damages.

It is to be noted that, although an unsatisfied judgment could constitute capital proceeds, depending on the circumstances, the relevant capital proceeds could be nil. This would be so if the judgment were worthless,¹⁰⁹ and the non-receipt rule set forth in s116-45 applied.

Guideline 5: where damages relate or compensation relates to a number of different heads and can't be apportioned

Suppose, for example, that the damages relate both to income and to capital. Suppose another case, where the asset underlying part of the damages is an asset other than the cause of action, but there is no

⁹⁷ (1993) 25 ATR 192.

⁹⁸ 31 ACSR 213.

⁹⁹ See s104-25(1) and *Hepples v FCT* (1991) 173 CLR 492 and see TR 95/35.

¹⁰⁰ See TR 95/35.

¹⁰¹ See s110-25(1) to (3).

¹⁰² (1993) 27 ATR 181.

¹⁰³ See TR 95/35.

¹⁰⁴ *Ibid.* See also [37.]

¹⁰⁵ See, eg, *Rabelais Pty Ltd v Cameron* (1995) 95 ATC 4552.

¹⁰⁶ See *ibid*; *Zim Properties v Procter* [1985] 58 TC 371; TR 94/29; TR 95/35, Egs 8 and 9; TR 99/19. As to forfeiture of deposits, see CGT event H1 in s104-5 and TR 94/21.

¹⁰⁷ See, eg, *Tuit v Exelby* 93 ATC 4293.

¹⁰⁸ *Supra.*

¹⁰⁹ See Div 116.

asset underlying the remainder of the damages other than the cause of action. Suppose, in each case, that the damages cannot be apportioned, and that they are not covered by an exemption, such as described above.

In this category of case,¹¹⁰ as in the last, the Commissioner treats damages as being capital proceeds for the release, discharge or satisfaction of the cause of action within the meaning of CGT event C2.¹¹¹

In this category of case, there may well be grounds for making a tax adjustment to the damages.

Guideline 6: cases which do not fall into any of the abovementioned categories

In such cases, the relevant CGT event may be D1 or if not D1, H2. These are events of last resort.¹¹² Depending on the circumstances, the Commissioner might treat the following as such cases: an *ex gratia* payment of compensation;¹¹³ compensation received for an undertaking not to compete; an award of punitive damages.¹¹⁴

Guideline 7: tax adjustments to damages

A tax adjustment occurs where damages are adjusted up or down to take account of taxation. (See below.) The Commissioner treats these in the same way as the basic award of damages or compensation. The tax adjustment may take the form of an indemnity. An indemnity is itself a CGT asset. The capital proceeds will be the market value of the indemnity.¹¹⁵

Guideline 8: costs and recovery of costs

The Commissioner may treat costs as part of the relevant cost base.¹¹⁶ Hence, he may treat the recovery of costs as a recoupment of that part of the cost base.¹¹⁷

3.7 Deductibility of compensation and damages payments

There are provisions, such as in s25-50 of the ITAA97 and Subdiv3AA of Pt III of the ITAA36 which allow you to deduct specific types of payments; but, in this paper I make only a few comments about deductibility under Div 8 of the ITAA97 (deductions) and the black hole expenditure provisions.

The general tests for determining whether a loss or outgoing falls within s8-1 are well enough known not to call for exposition here.¹¹⁸

It is to be noted that s8-1 (general deductions), unlike s6-5 (ordinary income) of the ITAA97 specifically provides for apportionment ('to the extent that'), so the limitations on apportioning parts of composite sums to income, referred to above, do not apply.¹¹⁹

Losses and outgoings of capital or of a capital nature are not deductible under Div 8. As to the distinction between losses and outgoings of revenue on the one hand and capital on the other, the test is that set out in *Sun Newspapers Ltd v FCT*¹²⁰ as elucidated by later authorities. A payment made for a restrictive covenant, for example, is generally, but not necessarily, made on capital account.¹²¹ It is also important to note that the fact a receipt is properly characterised as ordinary income does not mean that its payment is on capital account, although it may assist in reaching that conclusion.¹²² In view of the recent broadening of the 'black hole' expenditure provisions (see below), the distinction between losses and outgoings of capital on the one hand and revenue on the other has less importance in many cases than it once had.

¹¹⁰ Instances are given in Egs 12 and 13 in TR 95/35.

¹¹¹ See TR 95/35, [18].

¹¹² See ss102-25, 104-35(5) and 104-155(5).

¹¹³ See Eg 10 in TR 95/35.

¹¹⁴ See Eg 7 in TR 95/35.

¹¹⁵ See TR 95/35, [27].

¹¹⁶ See TR 95/35, Eg 3 and TR 94/29, [63]. See also [28] above.

¹¹⁷ See TR 95/35, Eg 4. As to the recoupment provisions, see above.

¹¹⁸ See such cases as *John Fairfax and Sons Pty Ltd v FCT* (1959) 101 CLR 30; *Peyton v FCT* (1963) 109 CLR 315; *FCT v Smith* 81 ATC 4144; *Magna Alloys & Research Pty Ltd v FCT* 80 ATC 4542, and more recently, *ANZ v FCT* 94 ATC 4026; *WD & HO Wills (Australia) Pty Ltd v FCT* 96 ATC 4223; *Sweetman v CIR (Fiji)* 96 ATC 5107; *Cape Flattery Silica Mines Pty Ltd v FCT* 97 ATC 4552.

¹¹⁹ See *Ronpibon Tin N.L. v FCT* (1949) 113 CLR 47.

¹²⁰ (1938) 61 CLR 337.

¹²¹ See *Dickenson v FCT* 98 CLR 460; *Buckley & Young Ltd v CIR (NZ)* 78 ATC 6019; *Riba Foods Pty Ltd v FCT* 90 ATC 4986.

¹²² See *FCT v Montgomery* (1999) 198 CLR 639.

3.7.1 Deductibility of costs

The principles described in 3.7 above apply.¹²³

3.7.2 Black hole expenditure: 5 year write off

Under ITAA97, s40-880, business capital expenses (subject to certain important exceptions) are deductible over 5 years. These could include damages or compensation payments of a capital nature.

If expenditure is not deductible, it may be capable of forming part of the cost base of a CGT asset under Div110 of Pt3-1 of the ITAA97.

4 GST

Under s9-10 of the GST Act,¹²⁴ a supply is any form of supply whatsoever including a creation, grant, transfer, assignment or surrender of any right and an entry into or release from an obligation, but generally does not include a supply of money: s9-15. A payment of damages or compensation may be consideration for a taxable supply (on which GST is payable)¹²⁵ and if so, the payer may thereby make a creditable acquisition.¹²⁶

Div19 of Pt2-4 of the Act provides for increasing and decreasing adjustments to GST amounts and input tax credit amounts. These arise because of adjustment events, such as a change in the consideration for a supply or acquisition.¹²⁷

There are special rules relating to insurance and claims settled under insurance policies.¹²⁸

GSTR2001/4 sets out the Commissioner's treatment of the GST consequences of court orders and out-of-court settlements. The ruling says that a court, in giving judgment, does not make a supply for GST purposes,¹²⁹ that the payment, in money, of a judgment debt will not itself be a supply for GST purposes,¹³⁰ and that the extinguishment of a judgment debt by its payment does not constitute a supply by the judgment creditor for GST purposes.¹³¹

As to out-of-court settlements, the ruling says¹³² that although releases and the like, are supplies, payments under the settlement are not treated as consideration for that supply, except where there is overwhelming evidence that the claim which is the subject of the dispute is so lacking in substance that the payment could only have been made for the discontinuance supply.¹³³

The ruling says that a payment made under a court order made wholly in respect of a claim for damages is not consideration for a supply,¹³⁴ and that a payment made under an out-of-court settlement to resolve such a claim, where there is no earlier or current supply¹³⁵ will not be consideration for a supply.¹³⁶ A current supply, to be contrasted with a discontinuance supply, is a new supply created by a settlement or judgment, such as a vesting order.¹³⁷

¹²³ See *Hallstroms Pty Ltd v FCT* (1946) 72 CLR 634, 647; *Magna Alloys & Research Pty Ltd v FCT* 78 ATC 4575; *Putnin v FCT* 91 ATC 4097; *Creer v FCT* 94 ATC 4454; *Elberg v FCT* 98 ATC 4454; *Davies v FCT* 2005 ATC 2331.

¹²⁴ *A New Tax System (Goods and Services Tax) Act 1999*.

¹²⁵ See s7-1 of the GST Act.

¹²⁶ See Div 11 thereof. See also s78-110 (insurance) and Div 99 for forfeiture of deposits. As to the forfeiture of deposits, see *Reliance Carpet Company Pty Ltd v FCT* 2006 ATC 2206 (AAT.)

¹²⁷ See s19-1.

¹²⁸ See Div78.

¹²⁹ See para60.

¹³⁰ See para61.

¹³¹ See para67.

¹³² See paras 54 and 106 to 109.

¹³³ An example would be a claim with merely a 'nuisance' value.

¹³⁴ See para110.

¹³⁵ As to which, see paras45 to 49.

¹³⁶ See para111.

¹³⁷ See paras 42 to 70.

The ruling states that the payment of court ordered costs or costs negotiated in a settlement¹³⁸ will not be consideration for an earlier or current supply, and that the costs order or settled amount should take account of any entitlement to an input tax credit of the parties to the original supply.¹³⁹

The ruling also deals with questions of apportionment.¹⁴⁰

Although the effect of the ruling is to place restrictions on the application of GST to awards of damages and settlements, it is still necessary for parties to litigation or settlements to consider whether or not there will or may be an adverse adjustment or liability to GST, and if so, to take it into account.

In some cases (such cases will, I think be rare), it will be appropriate to adjust the amount of compensation on account of GST (eg, if the liability to GST or adverse adjustment is part of the loss being compensated). In many cases, however, but for the occasion causing the loss, the GST in question would have been payable in any case. In cases (also likely to be rare) where there is uncertainty, it may be advisable to include a provision for adjustment of the amount of compensation, such as a 'gross up' clause. Account should be taken of input tax credits, and where, had the loss not occurred, GST would have been payable, that amount of GST should be deducted from the damages or compensation if they themselves are not consideration for a supply. This is an application of the *Gourley* principle and could apply where, for example, there is no current or earlier supply for which the compensation is paid, but the compensation is based on the value of property, turn over, or of revenue on the hypothesis of its being a supply, or is to be adjusted in accordance with the consumer price index.

If additional GST is payable, you may want to provide that the compensation is payable before the GST has to be paid.

GSTD2003/1 sets out the Commissioner's GST treatment of pre and post-judgment interest.

GSTR2003/6 deals with GST and relationship breakdowns.

5 STATE TAXES

Of course, in cases where they may apply, it is important also to consider the incidence of State taxes on settlements and the transactions to which they or some order may give rise. What has been said generally about taxation adjustments applies here as well.

6 DRAWING CLAIMS, SETTLEMENTS, INDEMNITIES, ETC

From all this, it will be apparent, as mentioned above, that the way in which you formulate your claim and the terms of any settlement, in addition to other circumstances, may affect the characterization and hence the incidence of tax. As others have pointed out, an understanding of the tax treatment of a compensation payment will be important if there is any element of choice involved in how the payment is to be made.¹⁴¹

The facts in *Dibb v FCT* [2004] ATC 4555 furnish an example. The assessability of an amount held to be an ETP was in issue. Various components of ETPs, including 'consideration in respect to personal injury', depending on the circumstances, may not be assessable income. Because the parties had not agreed that the plaintiff suffered personal injury, the terms of settlement pursuant to which the ETP had been paid did not enable an apportionment such that some part of the amount paid in settlement of all claims (several of which were for personal injury) could be so characterized.¹⁴²

A party's opinion as to the possible incidence of tax may affect the amount for which a party is prepared to settle. If a party overlooks the issue, he or she risks receiving too little or paying too much, that is, over compensating the plaintiff or being under compensated.

¹³⁸ The ruling says, 'in the circumstances described.'

¹³⁹ See para149.

¹⁴⁰ As does GSTR2001/8.

¹⁴¹ See AH Slater QC and JW Durack SC, 'Taxation of Judgments, Awards and Settlements', The NSW Bar Assoc, CLE Program, 9 October, 1995 at p28.

¹⁴² See 4570. See *Cowling v FCT* 2006 ATC 2395 (AAT) for a similar case, where the contention that ETPs were bona fide redundancy payments qualifying for concessional tax treatment was rejected owing to the matrix of relevant facts. See ITAA36, s27A(1)(ja) and (n) and ss26AC, 26AD, 27CB, 27E, 27F, 27G, Pt III, Div17, SubdivAAA.

Careful and considered analysis and communication are therefore called for, in cases where a characterisation one way or another will affect the incidence of tax.

Subject to anti-avoidance rules such as Pt IVA of the ITAA36, as a general rule, it is preferable to apportion identifiable amounts to items which qualify for exemption or concessional treatment.

One can provide for a multitude of uncertainties by drafting ever more elaborate clauses. Nevertheless, it should be remembered that any compromise, like many an award of damages, is likely to be no more than an approximation. Moreover, usually, the plaintiff does not get full compensation from a compromise. Hence, the approach to making taxation adjustments in awards of damages may not always be appropriate in negotiations for a compromise. There is always a risk that haggling over details will cause negotiations to break down, or prevent the reaching of a binding agreement that in hindsight the haggler would like to be able to enforce. There is also sometimes a virtue in simplicity. In most cases it is best to allow common sense to prevail.

The matter can be summed up thus:¹⁴³

On many occasions there will be little doubt into which category [taxable or non-taxable] the payment will fall. On some occasions, however, the position may not be as clear and it will then behove the lawyer [and, I may add, accountant]¹⁴⁴ advising the defendant to consider the possible implication of compensation paid pursuant to a negotiated settlement in which case there may be an opportunity to mould the basis on which the payment of compensation is made rather than to simply submit to a judgment.

7 RUNNING CASES WHERE TAXATION ADJUSTMENT AN ISSUE

7.1 Evidence

Although at least one case¹⁴⁵ suggests 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, the better view¹⁴⁶ (in the opinion of the writer) is that the plaintiff has to prove on the balance of probabilities that there is a more than fanciful risk that his loss and damage will include such liability. As to whether the plaintiff must go further and adduce evidence that enables the court to make a realistic assessment of the extent of the risk and range of amounts involved, there is a conflict amongst the relevant authorities.¹⁴⁷

Because CGT is imposed on net capital gains, the plaintiff's capital losses, net capital losses, and capital gains – past, present and future – may affect the assessment of damages and hence be relevant. Likewise, evidence of the plaintiff's income, profits, losses, and outgoings, may be relevant. For example, the defendant may wish to adduce evidence of the plaintiff's capital losses in order to prove that there is no real risk that the award of damages will increase the plaintiff's taxable income in any year.

Similar principles apply where other provisions for the assessment of income tax, or the incidence of other taxes may affect the quantum of damages.¹⁴⁸

It will be advisable for a litigant wishing to gain a tax adjustment in its favour to obtain the expert opinion of a tax practitioner.¹⁴⁹ To the extent that such an opinion were an opinion on matters of law rather than practice, it could be adopted as a submission of the litigant if not admitted as evidence. There is, however, authority that it could be admitted as evidence.¹⁵⁰ In addition, rulings could be tendered, and other evidence from the Australian Tax Office could be adduced. The Commissioner can be bound by

¹⁴³ Slater QC and Durack SC, 'Taxation of Judgments, Awards and Settlements', NSW Bar Assoc, CLE Program, 9 October, 1995.

¹⁴⁴ My addition.

¹⁴⁵ *Tuite v Exelby* 93 ATC 4293, 4303.

¹⁴⁶ See *Duke Group Pty Ltd (in liq) v Pilmer* (1999) 31 ACSR 213, 319; *Turner v TR Nominees Pty Ltd* (1995) 31 ATR 578, 596.

¹⁴⁷ In the *Duke Group* case, supra the plaintiff did not need to go further, but in *Osric Investments Pty Ltd v Woburn* [2001] FCA 1402, the Court rejected that approach. See also the *Carborundum* case, supra.

¹⁴⁸ See cases referred to above in section on relevance of taxation to the assessment of damages.

¹⁴⁹ See the *Osric* case, supra and *Namol's* case, supra.

¹⁵⁰ See *Namol Pty Ltd v AW Baulderstone Pty Ltd* 93 ATC 101 and see Slater QC and Durack SC, 'Taxation of Judgments, Awards and Settlements', NSW Bar Assoc, CLE Program, 9 October, 1995. See also the various Evidence Acts of the States and the C'th.

favourable private rulings.¹⁵¹ Otherwise, the ruling is mere evidence, which the court can reject, as it did in the *Carborundum* case.¹⁵²

In proceedings for the recovery of damages, it may be prudent for the plaintiff to seek orders for confidentiality, especially so as to protect the confidentiality of communications that could be privileged from production in proceedings with the Commissioner.

7.2 Remedy or relief

Where a litigant proves that there is a real risk that tax will have an impact on damages, there is controversy as to what relief is met.¹⁵³ Because of the system of self-assessment applying to taxpayers, a plaintiff's liability to tax may take years to be fixed with finality.¹⁵⁴ This is so even if the plaintiff agrees with the defendant to conditions, or obligations are imposed on the plaintiff by the court assessing damages, in either case requiring the plaintiff to expose the issues to the Commissioner in such a way as enable the plaintiff to contest an adverse assessment.¹⁵⁵

Having regard to these difficulties, in various of the cases cited, the court has granted one of the parties an indemnity,¹⁵⁶ or reserved liberty to apply.¹⁵⁷ Arguably, however, the grant of such relief offends against the principle that damages are to be granted once and for all. Nevertheless, where a plaintiff seeks an increase in damages owing to a tax adjustment, the plaintiff would be wise to apply for an indemnity as well. Furthermore, it may be prudent for the party granted any such relief (whether plaintiff or defendant) to apply for security.

7.3 Joinder of Commissioner

In the *Carborundum* case,¹⁵⁸ the Court commented that the Commissioner had not been joined as a party to the litigation in which damages were claimed, so of course he was not bound by the result. There is authority that the Commissioner cannot be joined as a party merely on the grounds that some tax adjustment to damages is in issue,¹⁵⁹ because he has no real interest in the outcome. This can lead to uncertainty and the risk of unfairness, eg, should the predictions of the court assessing damages turn out to be wrong. In some cases, it may be possible to overcome the problem by approaching the Commissioner for agreement to be bound by the result in the case, and by offering him as a condition of his agreeing to do so, the opportunity of making submissions as *amicus curiae*. Another option is to seek a private ruling.

In some cases, where the Commissioner has a real interest in the litigation, such as where the refunding of amounts paid to him is in issue, he may be a proper party and the court may make a declaration against him,¹⁶⁰ although there are specific statutory provisions dealing with that type of case.¹⁶¹

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¹⁵¹ See *Taxation Administration Act 1953*, Sch1, Pt5-5, especially s357-60.

¹⁵² *Supra*. On the advantages and disadvantages for each party of seeking a private ruling or relying on one in a suit for damages, see Slater QC and Durack SC, 'Taxation of Judgments, Awards and Settlements', NSW Bar Assoc, CLE Program, 9 October, 1995.

¹⁵³ A very useful discussion of the difficulties associated with this and of some possible solutions, is to be found in Slater QC and Durack SC, 'Taxation of Judgments, Awards and Settlements', NSW Bar Assoc, CLE Program, 9 October, 1995.

¹⁵⁴ According to TR 95/35 and TR 94/29, the plaintiff may be required to amend an earlier return on the receipt of damages or interest.

¹⁵⁵ One option for the plaintiff may be to include the income in his return, and if the return constitutes the assessment, or he receives a notice of assessment, object to it under the relevant statutory provisions in the *Taxation Administration Act 1953*.

¹⁵⁶ As in *Provan's* case and *Duke's* case, both *supra*. But an indemnity was refused in the *Carborundum* case, *supra* and in *Namol's* case, *supra*.

¹⁵⁷ As in *Rabelais Pty Ltd v Cameron* 95 ATC 4552 and *Turner's* case, *supra*. Another possibility is for the court to grant a stay or to require an undertaking.

¹⁵⁸ *Supra*.

¹⁵⁹ See *Provan's* case, *supra* at 4645 per Rolfe J citing *Gill v Australian Wheat Board* [1980] 2 NSWLR 795, 797; and *Spencer v Macmillans Trustees* [1959] SLT 41, 44, 49 and *Riches v Westminster Bank Ltd* [1947] AC 390; *Vanderval Trustees Ltd v White* [1971] AC 912.

¹⁶⁰ See *Oil Basins Ltd v C'th* 93 ATC 4947.

¹⁶¹ See, eg, TAA, Sch1, Subdiv18-B.

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