

More Taxing News

Capital Gains Tax on Compensation or Damages

Is nothing sacred? The possibility that damages verdicts or settlements may attract the tax man's beady eye is discussed by Neil Forsyth Q.C. and Peter Searle.

One facet of the Tax "Reforms" of recent years which has particular importance for barristers is the impact of capital gains tax on damages or compensation payments. If a cause of action arose on or after 20th September 1985 the proceeds may well be assessable pursuant to the provisions of Part IIIA of the Income Tax Assessment Act 1936 ("the Act"). Accordingly, the impact or possible impact of tax is very relevant to the amount claimed and the amount accepted in settlement or obtained in damages. From a defendant's point of view, there is also the possibility of realising a capital loss.

Broadly speaking Capital Gains Tax (CGT) applies where:

- (i) there has been a disposal or deemed disposal of an asset;
- (ii) the asset was acquired or deemed to have been acquired on or after 20th September 1985; and
- (iii) the disposal of the asset occurs on or after 20th September 1985.

For the purposes of CGT, 'asset' is defined in s.160A to mean -

"any form of property and includes:

- (a) an option, a debt, a chose in action, any other right, goodwill and any other form of incorporeal property.."

Rights which one acquires pursuant to the provisions of a contract are "property" and therefore assets for the purpose of Part IIIA of the Act. In O'Brien v. Benson's Hosiery (Holdings) Limited [1980] AC 562 the House of Lords held that the rights of an employer company under a contract of employment were property and therefore an asset even though they were not assignable and did not have a market value. The sum of 50,000 pounds received by the company in return for the surrender of its rights under the service agreement was held to have been for the disposal of an asset and therefore assessable as a capital gain.

Further, in Zim Properties Limited v. Proctor (1984) 58 TC 371 Warner J. was required to determine the issue of whether a sum received by a plaintiff in settlement of an action against his former solicitors in negligence was a capital sum derived from an asset and therefore assessable to capital gains tax pursuant to the provisions of the Finance Act 1965 (UK). The definition of "asset" there was drafted broadly along the lines of s.160A of our Act. Warner J. held, following O'Brien v. Benson's Hosiery, that the sum received by the plaintiff in settlement of such an action was a capital sum derived from an asset (being the plaintiff's claim in negligence against his former solicitors) and therefore assessable.

Given that an actionable claim is an asset subject to CGT, one must determine with some accuracy both the time at which the asset was acquired and the cost base (if any) of that asset. Many actions before the courts will be based on acts of alleged negligence which occurred prior to 20th September 1985, but where much of the damage has been suffered (and the writ issued) after that date. It is beyond the scope of this paper to provide examples which illustrate the difficulty in ascertaining the time a particular cause of action was complete.

All the complicated law concerning the time when a cause of action accrues for the purpose of the Limitations of Actions Act appears to be equally applicable for the purposes of CGT. An asset may be acquired not only by the entering into of a transaction, etc...but also by "the occurrence of any event": para 160M (21(f)).

Paragraph 160M(3)(b) provides that a change of ownership (disposal) shall be taken to have occurred by "the cancellation, release, discharge, satisfaction, surrender, forfeiture, expiry or abandonment" of an asset being a debt chosen in action or any other right. Thus, the recovery of judgment, or rights under a compromise, in relation to a cause of action which was acquired (or deemed to have been acquired) before 20th September 1985 may attract tax. In ascertaining the amount of relevant profit, there is to be deducted, from the consideration, receivable, the "indexed cost base" (if any).

In some instances the cost base of the asset to the plaintiff is likely to be the market value at the time the damage was suffered and that sum would in turn probably equal the damages awarded. Accordingly, no capital gain would arise. However, the cost base of the asset is often likely to be nil, and unless the gain is specifically exempt, the judgment debt (or settlement figure) would be included in the assessable income of the successful plaintiff.

Exemption of damages for personal injuries

Sub-section 160AB(1) contains an important exemption:

'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, or proceeding instituted or other act done or transaction entered into by the taxpayer in respect of such wrong or injury, shall be taken to have resulted in the taxpayer having incurred a capital loss.'

In the Explanatory Memorandum accompanying the CGT legislation the Treasurer stated that "damages for personal injuries or for libel, slander or defamation and insurance monies under personal accident policies" fall within this exemption of "any wrong or injury suffered by a taxpayer to his or her person or in his or her profession or vocation". Any cause of action not within the exemption is *prima facie* subject to the CGT regime.

It should be noted that sub-section 160ZB(1) specifically excludes the claim for a capital loss in respect of the personal wrong or injury claims specified therein. It is implicit that capital losses may be claimed by taxpayers in respect of other damages or settlement payments. Note, however, that capital losses are not deductible against assessable income generally, but only against assessable capital gains.

Mixed capital/income claims

In revenue cases, the courts have traditionally refused to dissect an "undissected lump sum" which includes both capital and income components (Allsop v. FC of T (1965) 113 CLR 341 and McLaurin v. FC of T (1961) 104 CLR 381, recently applied in FC of T v. Spedley Securities Ltd. 88 ATC 4126).

Thus, taxpayers have traditionally been able to obtain a financial advantage by settling a case for one undissected

lump sum which includes compensation for various heads such as loss of earnings, loss of goodwill and loss of capital assets. Although there may still be an advantage in such a technique as far as revenue items are concerned, it should be noted that Part IIIA of the Act specifically allows for apportionment. Sub-section 160ZD(4) provides:-

“Where any consideration...relates in part only to the disposal of a particular asset, so much of that consideration as may be reasonably attributed to the disposal of the asset shall be taken to relate to the disposal of the asset.”

Counsel should give consideration to assisting the Commissioner of Taxation in “reasonably attributing” a portion of the lump sum settlement figure to the disposal of particular assets.

Family Law Act transfers

Finally, it should be mentioned that Part IIIA specifically provides for roll-over relief from CGT where there is a court sanctioned or court directed transfer of assets between spouses under the Family Law Act. As from 28th January 1988 the roll-over relief is extended to court directed or court sanctioned transfers of assets between a company or trust and one of the spouses to the arrangement. As is often the case concerning income tax amendments in modern times, this extension of the roll-over relief provisions is contained in an announcement made by the Treasurer on 28th January 1988 and will not be embodied in legislation until the draftsman gets back from holidays.

Conclusion

This brief comment should illustrate that there are vast opportunities as well as pitfalls for members of the Bar in relation to the impact of CGT on damages claims. A plaintiff who settles a claim for \$100,000 might be very angry if he finds that the Commissioner of Taxation is entitled to take almost half of that amount. On the other hand a defendant who refuses to settle a claim for \$100,000 might be more than willing to settle a claim for \$175,000 if he can be assured that the full \$175,000 will be a claimable capital loss. In either event, both sides should be quite certain as to the type of asset they are dealing with, because the Commissioner is likely to be resistant to the idea of allowing a capital loss on the payment of an amount by way of compensation or damages if he cannot have the corresponding sum included in the plaintiff's assessable income. □

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Last with the First

"Judge Appointed

Justice Roderick Pitt Meagher QC, has been sworn in as a judge of the NSW Court of Appeal. Justice Meagher was appointed to fill the position left by Justice Michael McHugh, who now sits as a judge of the High Court. Justice Meagher, 56, became a barrister in 1960 and took silk 14 years later."

.....Sydney Morning Herald 10 March 1989.

His Honour was sworn in on 31 January 1989.

The Skeptical View

Skeptics (sorry about the American spelling) are not cynics - necessarily. They are not sarcastic - all the time.

What are Skeptics?

In Australia they are members of the Australian Skeptics, an association inspired by the Committee for the Scientific Investigation of Claims of the Paranormal (CSICOP) in the U.S.A. They deserve closer attention from the Bar.

Surprisingly few lawyers are members. Perhaps the title emphasises science and deters them, but in reality reason and logic - rational argument - are its foundations.

It is quite a respectable organisation. The American body has on its committee eminent persons including Isaac Asimov, Murray Gell-Mann, Stephen Jay Gould, Paul Kurtz, James Randi, Carl Sagan, Dick Smith and many others perhaps not so well-known in Australia.

The NSW Branch of the Australian Skeptics (P.O. Box 575, Manly 2095) has as its president a witty and patient man with an interest in Egyptology, among other things - Barry Williams. What does it do?

It offers a standing reward of \$20,000 (offered by Dick Smith and Phillip Adams, the patrons) to the first paranormal claim proven genuine under controlled tests and not attributable to any other non-psychic cause.

It awards two prizes at its annual conference at Easter (usually in Sydney or - as for 1989 - Canberra):

1. The Bent Spoon Award - for the most outrageous paranormal claim of the year (in 1988 Anne Dankbaar won it for her claimed discovery of the Colossus of Rhodes - complete with bulldozer scrapes. Peter Brock's "energy polariser" won in 1987).
2. The Skeptical Journalism Award - for the best reporting of a paranormal topic (in 1988 the ABC's Investigators won for its piece on a supposed "fuel polariser" which it was said would improve a car's fuel consumption).

Apart from lawyers, members include scientists in all fields, medical practitioners, teachers, journalists and magicians (who duplicate Yuri Geller's spoon-bending with ease). It is consulted regularly by the mass media for comment on current paranormal crazes.

Psychic and/or paranormal claims are made daily: astrology, telepathy, scientology, clairvoyance, channelling, water divining, telekinesis, tarot, ouija, homeopathy, graphology, crystallography, pyramidology and so on. The list is limited only by the imagination of the proponents. The gullible are gulled, the ignorant are parted from their money. The Skeptics struggle mightily to keep the facts before the public mind.

Its activities and interests are fun, intellectually challenging and useful in the field of consumer education and protection. Lawyers would revel in it - hence this article.

For \$15 per annum there are an annual convention, a quarterly magazine (tall tales but true), occasional talks and demonstrations, contact with CSICOP and its Legal and Consumer Protection Subcommittee and a wealth of information and entertainment.

There is no scope in Australia for a Legal Sub-Committee: but first become a member. Write to the address given above or contact me for an application form. Help the Bar broaden its horizons □

N.R. Cowderly Q.C.