INCOME TAX, CGT AND GST
ON JUDGMENTS AND SETTLEMENTS

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Introduction

1. In many circumstances, the receipt of a sum of money or other property following a judgment, or upon the settlement of litigation, may result in taxation implications for one or both parties to the litigation. The imposition of the income tax, the capital gains tax (**CGT**), and the goods and services tax (**GST**) in these circumstances often raises unsatisfactorily complex issues. Although a detailed consideration of those issues is beyond the scope of this paper, and may be found elsewhere,[2] it is essential that litigation practitioners understand, at least in broad terms, the potential taxation implications of judgments and settlements. This is particularly so following the High Court's recent decision in *Attwells v Jackson Lalic Lawyers Pty Ltd*,[3] whereby the advocate's immunity from suit established in *D'Orta-Ekenaike v Victoria Legal Aid*[4] was held not to extend to negligent advice that leads to a settlement agreement between the parties to litigation.

2. This paper is intended to arm practitioners with the essential knowledge required to identify when those issues may arise, and to explain how those issues are likely to be viewed by the Commissioner of Taxation (**Commissioner**) in some more common examples.

When might income tax, CGT and/or GST apply?

3. In considering when a judgment or settlement amount might be subject to some form of taxation, it is important to bear in mind a few basic principles about when income tax, CGT and/or GST will generally apply.

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1 This paper is a further iteration of a paper originally presented to the Revenue Law Section of the Commercial Bar Assocation in 1999, which was subsequently updated by the authors in 2008, by Mr Bearman alone in 2014 and 2015 and most recently by Mr Bearman and Ms Cameron in 2016. The authors gratefully acknowledge Ms Cameron's contribution to the 2016 version of this paper. Any errors in this paper are the responsibility of the presenter.

2 See for example: R Krever, *The Capital Gains Tax Consequences of Litigation* (1997) 71 ALJ 699; K Chalmers & J Evans *Pain But No Gain? Capital Gains and Compensation Receipts* (1996) 70 ALJ 617; C W Pincus, QC & S White, *Taxation of Compensatory Payments and Judgments* (2001) 75 SLR 378; C J Bevan, *GST and CGT: Implications for Judgments* (2002) 22 ABR 192.

3 (2016) 90 ALJR 572.

4 (2005) 223 CLR 1.

Income tax

4. Income tax is imposed by the *Income Tax Assessment Act 1997* (**the 1997 Act**), on income according to ordinary concepts,[5] as well as statutory income (amongst other things).[6] As a general rule, the amount of a judgment for damages, or the amount of a settlement sum paid to a plaintiff, will be counted as income if it was paid as compensation for an amount that would have been income according to ordinary concepts, if it had not been denied to the plaintiff. Put another way, the fact that a taxpayer is denied an amount of income by the conduct of another, and is compelled to recover that amount by litigation, does not alter the character of the amount once the taxpayer finally receives it.[7]

5. Whether what is recovered by way of judgment or settlement is 'income', of course, depends upon a characterisation of the subject matter of the litigation. As an example, if unpaid leave entitlements were sued for in an unfair termination case, an award of damages for those entitlements, or the payment of a sum to settle that claim, would necessarily be income. Thus, the critical question is, what is the character of the amount (or amounts) sought to be recovered by the litigation?

6. Any interest claimed in proceedings – whether pre or post judgment – will almost always be income as well.[8] That will particularly be the case where the interest is calculated by reference to a principal income amount that was identifiable at the time of the cause of action arising. For example, in a claim for unpaid earnings, interest would be calculated by reference to the specific amount of earnings. In the Commissioner's view, pre-judgment interest paid in such a case will be assessable income.[9]

7. An exception to this general rule applies in the case of claims for personal injuries. In *Whitaker v Federal Commissioner of Taxation*[10] – a case concerning damages awarded for personal injury – it was held that pre-judgment interest will be characterised as capital in circumstances where a principal amount was not quantified at the time the cause of action arose but was instead quantified at the time of judgment. The Commissioner in practice treats that decision as applying to all pre-judgment interest in respect of personal

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5 Section 6-5(2) of the 1997 Act.
6 Section 6-10 of the 1997 Act.
7 *Glennan v Federal Commissioner of Taxation* (1999) 41 ATR 413.
8 C.f. *Steele v Deputy Commissioner of Taxation* (1999) 197 CLR 459.
9 ATO ID 2003/404.
10 (1998) 82 FCR 261.

injury cases.[11]

Capital Gains Tax

8. CGT will generally apply if a "CGT Event" occurs in respect of a "CGT Asset" and results in a capital gain to a taxpayer.

9. Section 108-5(1) of the 1997 Act defines a CGT Asset as "any kind of property or a legal or equitable right that is not property". Given the breadth of this definition, multiple CGT Assets may exist in connection with litigation. Possible examples include:

   (a) an underlying asset (such as real estate, shares, or goodwill) which is the subject matter of the litigation;

   (b) a contractual, tortuous or statutory right which is the subject matter of the litigation, and which can constitute a CGT asset;

   (c) the terms of any settlement of the litigation, as these terms give rise to legal rights and therefore may themselves constitute a CGT Asset;

   (d) the cause of action giving rise to the litigation itself; and

   (e) a judgment debt or rights arising from Court orders which may be considered a CGT Asset.

10. A capital gain occurs where the 'capital proceeds' received on the happening of the CGT Event exceed the 'cost base' of the CGT Asset to which the CGT Event happened. Capital proceeds will include any money or other property received on the disposal of a CGT Asset, while the cost base of an asset may consist of up to five "elements":[12]

   (a) the money paid for an asset, or the market value of property transferred in consideration for the asset;

   (b) incidental costs incurred to acquire, or that relate to, the asset which have not been deducted (eg, legal fees);

   (c) costs of owning the asset which have not been deducted (eg, interest on a loan, cost of maintenance);

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11 ATO ID 2002/473; *quare*, whether *Whitaker v Federal Commissioner of Taxation* (1998) 82 FCR 261 has application beyond personal injury cases.

12 See s 110-25 of the 1997 Act.

(d) capital expenditure incurred to increase or preserve the asset's value, or install or move the asset; and/or

(e) expenditure to establish, preserve or defend your title to the asset or a right over the asset.

11. In the context of litigation, the breadth of elements (b) and (d) above means that most legal costs should be able to be recognised in the cost base of 'assets' disposed of in a settlement, (although where a proportion of the legal costs relate to recovery of an income amount, that portion may instead be able to be claimed as a deduction and so excluded from the cost base). It should be noted however, that the cost base of assets cannot include any amount of the cost that is 'recouped' by a taxpayer, including through litigation, unless the recoupment is included in the taxpayer's assessable income.[13]

12. Where the cost base of an asset exceeds the capital proceeds, a capital loss will arise. Capital losses can be used to offset other capital gains derived by a taxpayer but cannot be deducted against assessable income.

13. Where, after adjusting for any CGT discounts or small business concessions, the total of all capital gains or losses made by a taxpayer during the year is a net capital gain, the amount of the gain is included in a taxpayer's assessable income for income tax purposes. The expression CGT is in this way somewhat of a misnomer: no separate Act of Parliament imposes taxation on capital gains, rather they are statutory income on which income tax is imposed under s 6-10 of the 1997 Act.

14. A number of different CGT Events might be triggered by a judgment or settlement. Where more than one CGT Event might apply, the one to use is the one "most specific to the situation".[14]

15. The most likely CGT Events which may apply in the circumstances of litigation include where:

a) you "dispose of a CGT asset" (**CGT Event A1**).[15] The 1997 Act defines a disposal as requiring a "change of ownership [which] occurs from you to another

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13 Section 110-45(3) of the 1997 Act. See generally the 'assessable recoupment' provisions in subdivision 20-A of the 1997 Act.

14 Section 102-25(1) of the 1997 Act.

15 Section 104-10(1) of the 1997 Act.

entity";[16]

b) a CGT asset you own is lost or destroyed (**CGT Event C1**).[17] This event "happens" at the time compensation for the asset is first received. If no compensation is received, then the event happens at the time the loss is discovered or the destruction occurs;[18]

c) your ownership of an intangible CGT asset ends by the asset, amongst other things:
   i) being redeemed or cancelled; or
   ii) being released, discharged or satisfied; or
   iii) expiring; or
   iv) being abandoned, surrendered or forfeited

   (**CGT Event C2**).[19] This Event is relevant to almost every litigation settlement, as the cause of action under the litigation will have been "released, discharged or satisfied" or "abandoned, surrendered or forfeited";

d) you create a contractual right or other legal or equitable right in another entity (**CGT Event D1**).[20] One example in the context of a settlement might be the creation of a right by the inclusion in a deed of settlement of a non-competition clause or a restrictive covenant, in return for compensation; and

e) if no other CGT Event applies, where:
   i) an act, transaction or event occurs in relation to a CGT asset you own; and
   ii) the act, transaction or event does not result in an adjustment being made to the asset's cost base or reduced cost base (**CGT Event H2**).

Commissioner's ruling on CGT and judgments and settlements

16. The application of the CGT is particularly difficult in the context of judgments and settlements as there are generally multiple CGT Events that happen in respect of multiple CGT assets. To overcome these difficulties, the Commission issued a ruling in 1995, TR

[16] Section 104-10(2) of the 1997 Act.
[17] Section 104-20(1) of the 1997 Act.
[18] Section 104-20(2) of the 1997 Act.
[19] Section 104-25 of the 1997 Act.
[20] Section 104-35(1) of the 1997 Act.

95/35;[21] it provides how the Commissioner will apply the CGT provisions to judgments and settlements. Unfortunately, the ruling often creates as many problems as it solves.

17. It has been said that, in TR 95/35, "the Commissioner's approach is pragmatic, if not entirely consistent in terms of the underlying legal basis".[22] That somewhat understates the position: in considering the potential taxation approach to applying CGT to judgments and settlements it is often necessary to consider both the legal position and the Commissioner's approach, which may not always be *ad idem*. In many cases, the Commissioner's position will be beneficial. However, that is not necessarily the case.

18. In essence, TR 95/35 adopts what is called the 'look-through' approach, that is, where compensation is paid that can be identified as relating to some underlying asset, the Commissioner will treat the compensation as relating to that asset. Hence, where compensation is paid for an asset that has been loss or destroyed, he would apply CGT Event C1 and treat the compensation as payment for the lost or destroyed asset under that CGT Event, rather than for the right to claim compensation for its destruction.

19. Where an asset is merely damaged or not entirely lost, rather than impose CGT on a compensation payment for a damaged asset, the Commissioner treats the amount as a recoupment of the asset's cost base.

20. For example, say a truck is badly damaged in a motor accident. The truck cost $300,000. The owner sues and $100,000 in damages is eventually awarded. The Commissioner will then treat the $100,000 as tax-free but reduce the cost base of the truck to $200,000.[23] Hence, when the owner later sells the truck for $250,000, he has a capital gain of $50,000. That is, the Commissioner effectively allows a deferral of the taxation consequences.

21. However, strange results may arise if an asset has only a nominal cost base; if the compensation exceeds the cost base, the Commissioner treats the excess as tax-free.[24] Hence, there is a windfall gain to the taxpayer. An example might be an award of $500,000 for damage to a house, which has a cost base of $50,000. The cost base would

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21 Although the CGT provision were re-written in the 1997 Act from the original provisions contained in the *Income Tax Assessment Act 1936* (**the 1936 Act**), the earlier ruling is deemed to apply to the re-written provisions: s 356-85 to Sch 1 of the *Taxation Administration Act 1953*.

22 R Krever, *The Capital Gains Tax Consequences of Litigation*, (1997) ALJ 699, p. 706.

23 For assuming the costs to repair the truck were risk deductible – if they were the Commissioner will treat the $100,000 as an assessable recoupment under subdiv 20-A of the 1997 Act.

24 TR 95/35, [7].

reduce to zero. And up to $500,000 would be tax-free (subject to how much of the expenditure to repair the house was recouped by the damages award). When the house later sells for $700,000, tax on an additional $50,000 will be paid.

22. The look through approach is particularly useful in the case of exemptions. Where a settlement (or judgment) sum is paid for an exempt amount (say, for personal injuries), the Commissioner will look through to the exemption.

23. However, where it is not possible to attribute the settlement or judgment sum to a particular underlying asset (or assets), the Commissioner may simply treat the compensation as being for the disposal of some right in the litigation, i.e. to seek compensation.

Income tax over CGT

24. It should be noted that an amount received in consequence of a judgment or settlement may be both income according to ordinary concepts and also subject to the operation of the CGT. In that instance, the amount of any capital gain is reduced up to the extent the amount is otherwise included in assessable income,[25] with the consequence that any capital losses could not be utilised to reduce the burden of tax. A capital gain is also so reduced to the extent an amount received is both exempt income and also a capital gain.[26]

25. The converse generally does not apply. Exemptions from capital gains tax (discussed below), the operation of the 50% CGT discount,[27] the CGT small business concessions,[28] and other forms of exemption[29] or rollovers do not apply to income. Of course, special concessions relating only to income may apply. For example, payments to a terminated employee may be concessionally treated as eligible termination payments.

Some kinds of payments are exempt

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25 Subsections 118-20(1), (4) of the 1997 Act. The reduction does not apply to certain dividends for share buy-backs, or certain franked distributions: see s 118-20(1B).

26 Sections 118-20(1)(a) and 118-20 (1A)(a) of the 1997 Act in respect of "exempt income" as defined by s 6-20; and s 118-20(4) of the 1997 Act for "non-assessable, non-exempt income" as defined by s 6-23 of the 1997 Act.

27 Division 115 of the 1997 Act.

28 Division 152 of the 1997 Act; although the small business concessions are unlikely to operate in respect of an award made by a court's judgment, they may well be relevant to private settlements of litigation.

29 Especially on the break-down of a marriage, or domestic relationship: see s 118-75 of the 1997 Act.

26. There are important exemptions, or exceptions, to the general rules relating to income tax and CGT in respect of particular kinds of payments that might be received in consequence of a judgment or settlement.

Personal injuries and other 'wrongs'

27. As noted above, compensation for personal injuries and certain other wrongs attracts an exemption from CGT. The exemption is contained in s 118-37(1) of the 1997 Act:

> "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;
>
> ..."

28. A 'wrong' for the purposes of this provision is not necessarily limited to a personal injury; it may also include claims for defamation, sexual harassment, professional negligence of a solicitor who fails to institute a personal injury claim, unlawful discrimination and wrongful dismissal.[30]

29. This exemption, combined with the fact that compensation for lost earning capacity will escape ordinary taxation, means that a substantial portion of personal injury payouts are not taxed.

30. Section 116-20 of the 1997 Act makes it clear that capital proceeds being compensation or damages may be paid in a form other than money. Moreover, the Commissioner has stated that compensation or damages paid can be in a form other than cash.[31] But care must be taken with this statement. Although the receipt of the property might be exempt to the recipient, a disposal of the property by the payer would fall under CGT Event A1, resulting in CGT consequences to the payer.

31. Division 54 of the 1997 Act also provides that income from certain annuities purchased in consequence of structured settlements or by court orders is exempt income and hence, not assessable income.[32] The exemption is necessary to prevent the conversion of CGT exempt damages or compensation paid for "any wrong, injury or illness" suffered by a

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30 See the examples set out in TR 95/35.

31 Taxation Determination (**TD**) 30.

32 Section 54-25 of the 1997 Act.

plaintiff[33] into assessable income by the purchase of an annuity. There are numerous specific requirements for the operation of the exemption that narrows its operation. For example, the claim must not be made against an employer, or the associate of an employer, or made under workers' compensation or equivalent laws.[34]

32. Post-judgment interest received in connection with personal injury damages is expressly exempted from taxation.[35]

Marital breakdowns

33. There is an exemption for capital gains made in consequence of marital breakdowns. However, the exemption is limited to the operation of CGT Event C2 (where your ownership of an intangible GST Asset ends by the asset being, relevantly, abandoned, surrendered or forfeited).

34. The exemption provides that "a capital gain or capital loss you make as a result of CGT Event C2 happening is disregarded if you make the gain or loss in relation to a right that directly relates to the breakdown of a relationship between spouses", if there is a separation and "no reasonable likelihood of cohabitation being resumed" at the time of the CGT event.[36]

35. The example given in the legislation is as follows:

> ". . . Maude receives an amount from Claude by way of a settlement directly related to the breakdown of their marriage. CGT event C2 would happen to Maude on satisfaction of her legally enforceable right to the amount. Any capital gain or loss that Maude makes in these circumstances is disregarded".

50% CGT Discount

36. As mentioned briefly above, there is a 50% discount available for certain capital gains: Div 115 of the 1997 Act. In effect, a net capital gain made by an individual or trust estate will be discounted by 50% in prescribed circumstances and a net capital gain made by a complying superannuation fund or life insurance will be discounted by 33⅓% in those circumstances. Companies that are not trustees are not entitled to the CGT discount.

37. The key qualification for a discount is that an asset must be held for 12 months prior to

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33 Sections 118-37(1)(a), (b) of the 1997 Act.

34 Section 54-10(1)(c) of the 1997 Act in respect of settlements; s 54-10(1A)(c) in respect of orders.

35 Section 51-57 of the 1997 Act for 1998 and later years of income; s 23GA of the 1936 Act for the 1992 to 1997 years of income.

36 Section 118-75 of the 1997 Act.

the occurrence of the CGT Event which gave rise to the capital gain.[37]

38. Additionally, for present purposes, the discount cannot arise by the happening of CGT Event D2 and/or H2.[38] Specific restrictions also apply to certain transactions involving shares or interests in trusts.[39] The operation of the CGT discount for trusts is also subject to additional restrictions and modifications.[40]

Pre-CGT assets

39. An exemption from CGT is provided for gains realised upon the disposal of assets acquired on or before 20 September 1985. Where a judgment or settlement sum relates to specific rights (such as a cause of action) that were acquired or accrued to the taxpayer before that time, the extinguishment of those rights would not give rise to any capital gain. Where the settlement related partly to pre-CGT rights and post-CGT rights, apportionment of the capital proceeds would be required under section 116-40 of the 1997 Act.

Replacement asset "roll-overs"

40. Relief from CGT can also be obtained when compensation received for the loss or destruction of an asset (or part of an asset) is used to replace that asset. The rules to obtain such relief are very specific[41] and consequently it is difficult to make general comment on their application. However, some general matters are as follows:

    (a) money (or another asset) must be received for the loss or destruction of the asset;

    (b) if money is received:

        (i) the money must be spent on acquiring another asset, or in restoring the asset that was lost or destroyed; and

        (ii) some of the expenditure must occur within 12 months of the loss or destruction occurring; and

    (c) if property is received, the first element cost base of the new asset will be deemed to be the cost base of the old asset.

41. If this rollover does apply and only money is received, the practical effect is that the gain arising from the CGT Event triggered by the loss or destruction will be reduced by the

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37 Section 115-25(1) of the 1997 Act.

38 Section 115-25(3) of the 1997 Act.

39 Section 115-45(1) of the 1997 Act.

40 Subdivision 115-B of the 1997 Act.

41 The rules are set out in Sub-div 124-B of the 1997 Act.

amount that is applied to acquire or restore the lost or destroyed asset. Special rules apply to determine the gain when only a portion of the asset is lost or destroyed, or if both money and an asset are received by way of compensation.

42. This rollover will also apply in certain cases of compulsory acquisitions by government agencies.

Other rollovers

43. There is a range of rollovers available for exchange of shares, or rights in shares, extension of leases and other transactions that may arise in the course of settling a legal proceeding. This paper does not cover each of these other rollovers, but in any case where a new asset is received in place of an old asset as part of a settlement, or in place of a right to compensation, it will be necessary to consider whether any alternate rollover relief could be available.

Structured vs lump sum settlements

44. If a claim is made for multiple heads of loss, some of which represent lost income and some of which represent lost capital, a settlement on the basis of the payment of an un-dissected lump sum will be capital.[42]

45. This may be attractive as an approach in cases where, for example, the plaintiff may be entitled to a 50% CGT discount (such as where the plaintiff is an individual or a trustee), but it will not always result in a benefit. For instance, if the subject matter of the litigation concerned exempt income, a plaintiff would prefer the receipt of a judgment or settlement to be treated as income, as the receipt would be income tax and CGT-free. Another example might be litigation about a reduction in value of particular capital asset with a high cost base, which would not otherwise be deductible were the settlement or judgment sum to be treated as income.

46. Particular care needs to be taken in the cases involving multiple heads of damage where the different amounts claimed may be eligible for various exemptions and partial exemptions. For example, where a settlement sum was dissected between lost salary, an eligible termination payment and pain and suffering, the first would be assessable

[42] *McLaurin v Federal Commissioner of Taxation* (1961) 104 CLR 381; *Allsop v Federal Commmissioner of Taxation* (1965) 113 CLR 341.

income, the second, the Commissioner would accept any reduction in tax, and the third would be tax-free.

47. Accordingly, other than where there will be a specific benefit, or no difference in the taxation outcome, it is generally preferable for settlements dealing with multiple claims to allocate particular payments to particular heads of claim rather than to provide for an un-dissected lump sum. Subject to the operation of the general anti-avoidance rules, this approach allows some measure of control over the treatment of the sums received.

48. For example, in *Public Servant v Federal Commissioner of Taxation,*[43] the Administrative Appeals Tribunal considered a private ruling on whether a payment under a settlement deed was income or capital. The deed expressly provided that it represented general damages but linked the payment to the taxpayer's cessation of employment. Based on the narrow facts recorded in the ruling the Commissioner had ruled it was an Employment Termination Payment and subject to tax on that basis. The Commissioner was successful in maintaining this position in the Tribunal. However it is apparent that the Tribunal held the view that payment was arguably in respect of personal injury in settling the alleged discrimination claim, and therefore not subject to tax at all. Thus, if the settlement deed had have specified that the payment was for general damages without expressly drawing a link to the cessation of employment, or allocated the settlement sum across different heads of the claim, then the tax outcome may have been more favourable to the taxpayer. With an increase in claims for distress, humiliation and discrimination, this issue may have growing importance in future settlements.

49. If a claim is *only* for an income (non-capital) amount, or if the settlement itself identifies amounts paid in respect of a claim for an income amount, those amounts will nevertheless be assessed as income and not subject to the CGT provisions.[44] The Commissioner's general statement of policy asserts a wide view of what constitutes such identification.[45] However, in specific instances, the Commissioner has taken a narrower approach. For example, he has in the past determined that a settlement payment was capital, not income where it was made to an individual for "[redemption of] the taxpayer's entitlement to

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43 [2014] AATA 247.

44 *McLaurin v Federal Commissioner of Taxation* (1961) 104 CLR 381, per Dixon CJ, Fullagar and Kitto JJ, at 391.

45 TD 93/58.

weekly compensation payments and medical expenses and to surrender their rights to any other future claim against their employer".[46]

50. Whether such an identification of income and capital amounts forming part of a lump sum settlement will have any effect on its treatment for CGT or income tax purposes will generally depend on the terms of the agreement reached between the parties, and how it was achieved. For instance, in *McLaurin v Federal Commissioner of Taxation*[47] a defendant tortfeasor internally calculated a lump-sum settlement offer by reference to identifiable amounts of income and capital, which was accepted by the plaintiff. Following payment of the settlement sum, the Commissioner sought to assess part of the sum as income, by reference to the defendant tortfeasor's calculations. However, as those calculations were not shown to the plaintiff, the High Court held that they could not and did not form part of any settlement agreement, with the result that no income amounts could be 'identified' and the settlement sum was to be treated as a wholly capital receipt.

51. Where the parties make no allocation, and there is no basis upon which to treat a sum received as being income, the Commissioner takes the approach of treating the compensation as being in return for the ending of the cause of action under CGT Event C2. In that case, there is no "looking through". Further, it is rarely the case that a cause of action has a significant cost base, as money and property are usually principally expended in respect of matters relating to the underlying dispute, not the litigation. Hence, if in the above example, the parties settled on the basis of an un-dissected lump sum, the Commissioner would not allow either any reduction for the eligible termination payment and no exemption for the pain and suffering award. Another example might be a settlement involving the loss of a pre-CGT asset, together with other claims. If no allocation was made, the benefit of the CGT free status of that asset would be lost. It is the author's view that the Commissioner is correct in this approach.[48]

52. Another difficulty where there is no allocation is that CGT Event C2 applies to the cause of action coming to an end. The CGT discount is only available if an asset is held for more than 12 months. Hence, there is a built in disincentive for a litigant to promptly sue and settle; if all steps took place within a year, significantly more CGT could be payable

46 ATO ID 2003/707 (now withdrawn).

47 (1961) 104 CLR 381.

48 Which has also been accepted by the Administrative Appeals Tribunal: *Coshott v Federal Commissioner of Taxation* [2014] AATA 622.

(depending on the marginal tax rate of the taxpayer).

53. An example of the precision with which lawyers should consider the incidence of tax on a settlement arose in *Murdoch v FCT*.[49] The taxpayer was the income beneficiary of a number of trusts established after her husband had passed away. However, by reason of the way the trustees had invested the corpus of the trusts the income of the trusts remained relatively low even though the capital of the trusts grew substantially. In the early 1990s legal advice was obtained that the taxpayer might have a substantial claim that was, in substance, due to the fact that her income from the trusts was lower than it would otherwise have been.

54. In satisfaction of this claim, a settlement was entered into and the trustees agreed to pay $85m to the taxpayer. The terms of the settlement deed recorded:

> "J. Dame Elisabeth has claimed that:
>
> (i) the pursuit of the Investment Policy by the trustees of the Trusts:
>
> > • has not given rise to any exceptional increase in income of the Trusts but has greatly increased the value of the corpus of the Trusts; and
> > • involved significant risk for the beneficiaries of the Trusts, which risk was not properly rewarded in the case of Dame Elisabeth to the extent that she only had an income interest under the Trusts;
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> (ii) in pursuing the Investment Policy, the trustees of the Trusts from time to time have since the death of the Settlor breached their trust duties to Dame Elisabeth as a life tenant;
> …
> …
> L. It has therefore been agreed that Dame Elisabeth, as the life tenant under the Subject Trusts, having shared in the risk of investing in the investments of the Subject Trusts, and in consideration of her releasing:
> (i) The Current Trustees and any former trustees under the Trusts from any claims by her against them for breach of trust or otherwise in relation to following the Investment Policy in relation to the investments of the funds of the Subject Trusts and of the other of the Trusts; and
> (ii) The assets of the Subject Trusts and the other of the Trusts (being assets which Dame Elisabeth is not entitled to be paid as income of the Trusts) from any claims Dame Elisabeth has or may have upon or in respect of them other than her right to be paid a proportion of the undistributed current income and the future income of the Subject Trusts and any interest she may have in the capital and income of the other of the Trusts, should be entitled to the following:
> (iii) that the ordinary shares in Cruden Investments (the "Cruden Investments Shares") comprising the assets of the Subject Trusts should be in whole or in part realised (by way of sale of some of such shares or partial return of capital on all of such shares) to raise $85,087,176 in Australian currency; and

49 [2008] FCAFC 86.

> (iv) that such $85,087,176 be paid to Dame Elisabeth or as she may direct as the absolute property of Dame Elisabeth to deal with as she in her full and complete discretion may determine".

55. The Commissioner assessed the taxpayer on the basis that the $85m was in substitution for lost income and therefore the amount should be assessed as ordinary income.

56. The taxpayer disputed the tax assessment. The Administrative Appeals Tribunal initially agreed with the Commissioner. However, the Full Court allowed an appeal and concluded that the amount was not income, but was instead capital. The reason for the Full Court's decision was that although the claim against the trustees arose by reason of the investment policy of the trusts leading to a lower income stream to the taxpayer, the precise nature of the claim was a *Phipps v Boardman* claim against the trustees for breach of their fiduciary duties. The Court said:

> "[14] The claim made by the applicant appears in recital J and cl 2.1 of the Settlement Deed (set out at [4] and [5] above, respectively). We think it fair to characterise the claim given up as a *Phipps v Boardman* claim.
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> [15] In *Phipps v Boardman*, the House of Lords applied a principle that it had recognised in *Regal (Hastings) Ltd v Gulliver* [1942] 1 All ER 378 (*Regal (Hastings) Ltd v Gulliver* is reported as a note to *Phipps v Boardman* [1967] 2 AC 134) following a line of cases perhaps led by *Keech v Sandford* (1726) Sel Cas T King 61 (25 ER 223). In summary, that line of authority is to the effect that a trustee or other fiduciary is accountable for a profit he or she has made from a breach of fiduciary duty, even though the profit is one that the beneficiary to whom the trustee or other fiduciary is liable to account could not have made.
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> …
>
> [27] In our respectful opinion, the Tribunal erred in failing to characterise properly the character of the claim that the applicant gave up and, therefore, the character (income or not) of the Lump Sum that she received for giving it up. The applicant's claim was to an accounting for a capital profit or gain made by Mr Murdoch and to an entitlement to a constructive trust over the assets of the trust estate, and she was paid the Lump Sum in satisfaction of those claims. The Lump Sum was not income."

57. The right the taxpayer had was not to recover her theoretical lost income but was a right to claim from the trustees whatever benefit they had received. And in this case that benefit was the increased corpus of the trusts: that is, the claim was treated as being for a capital amount for tax purposes – and thus not ordinary income.

Goods and Services Tax

58. GST may be imposed under the *A New Tax System (Goods and Services Tax) Act 1999* (**the GST Act**) if some part of a judgment or settlement amount could be characterised as consideration for a 'taxable supply'.

59. A taxable supply for the purposes of the GST Act includes "a creation, grant, transfer, assignment or surrender of any right"[50] and also "an entry into, or release from, an obligation", "to do anything", or "to refrain from an act", or "to tolerate an act or situation", or any combination thereof.[51]

60. Because of the breadth of this definition, most settlements will give rise to what might be considered a taxable supply. On the other hand, a judgment is not considered to be a 'taxable supply' by the Court to the successful plaintiff.

61. It is important to remember that GST is a tax on the recipient of consideration, not on the person paying the consideration, and only in certain circumstances. Where, for example, a defendant pays an amount to a plaintiff to settle a proceeding, GST will be imposed upon the plaintiff if and only if:

a) the plaintiff is registered or required to be registered for GST; and

b) the payment is in respect of its enterprise (the plaintiff's enterprise being, effectively, the business activity in respect of which it is registered).

62. If both of these criteria are satisfied, and subject to some exceptions, the plaintiff will be liable to GST being 1/11th of the GST inclusive price for the taxable supply (i.e. the ex GST amount plus 10%). The plaintiff will then be able to issue a tax invoice and the defendant (if also registered for GST) will be able to claim a credit for the GST, however it should be noted that a credit to the party paying an amount as consideration for a taxable supply (in this example the defendant) only arises if the recipient of the consideration (i.e. the plaintiff) was liable to pay GST.

63. However, if the plaintiff does not satisfy either of the above criteria, there will be no GST imposed upon it. In such a case, even if the defendant were registered for GST, no credit would arise to it. Accordingly, the defendant may wish to settle for 1/11th less to account for the lack of any input credit being available to it.

64. Where the above criteria are satisfied by a plaintiff but the defendant is not registered for GST (or the defendant is not entitled to a credit for some other reason), the plaintiff will nevertheless be liable to GST on 1/11th of the GST inclusive amount, but the defendant

50 Section 9-10(2)(e) of the GST Act.
51 Section 9-10(1)(g) of the GST Act.

will not receive a credit.

65. Finally, if the above criteria are not met by a plaintiff and the defendant is also not registered for GST, there will be no GST consequences for either.

66. The GST is, as noted above, imposed on the plaintiff. Hence, if a settlement were for a fixed sum without reference to GST, the GST would be 1/11th of that fixed sum; indeed, the GST Act assumes that all supplies are at GST inclusive prices. For that reason, the GST Act does not contain any statutory basis for the price of a supply to be increased by 10%. However, there is nothing to prevent parties from agreeing a price on a GST exclusive basis. The parties might in that case choose to include a "GST Clause" in their settlement agreement to provide that if the plaintiff has to pay GST, the price increases by 10%. Assuming the defendant is entitled to claim a credit for the GST component that they pay, the transaction is neutral of tax to both parties (leaving to one side timing differences between the plaintiff's obligation to pay the tax and the defendant's ability to receive a credit or refund).

67. The application of these rules can be particularly confusing if there are multiple supplies arising from payments in respect of multiple claims. In particular, where there are claims are being mutually released, there may well be taxable supplies in both directions.

68. The Commissioner sensibly accepts that in an ordinary case, an award of damages by a court and its payment is not a taxable supply by the court.[52] However, the Commissioner also asserts in such cases that if there is a sufficient nexus between an amount ordered and a supply, GST may be payable on an apportioned sum.[53] That is because the Commissioner treats court orders in the same way he treats settlements, which are discussed below. This approach has been found by the NSW Supreme Court to be incorrect, as an award of damages made by a court is payable solely in consequence of the court's order, not in consequence of the underlying dispute.[54] The Commissioner's position relies upon s 9-15(2A) of the GST Act. That section states, in the context of defining "consideration" for the purposes of the GST, that "[it] does not matter . . . whether the payment, act or forbearance was in compliance with an order of a court".

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52 GST Ruling (**GSTR**) 2001/4, [60] and see the cases referred to at [57]; and see further, [112]-[114].

53 GSTR 2001/4 at [115]-[116].

54 *Padstow Corporation Pty Ltd v Fleming (No 3)* [2013] NSWSC 24, at [34]; see the 2008 version of this paper op. cit. fn 1, at p. 11 there referred to.

However, although arguably the section does not operate in the manner contended for by the Commissioner, the position is unclear. On one view, the section may operate in circumstances in which a court order compelled particular action. For example, payment made pursuant to a mandatory injunction, payments made pursuant to orders for restitution of a specific sum, or amounts paid pursuant to an accounting might all constitute consideration for an underlying supply. In *quantum meruit* cases, the Victorian Supreme Court has said that it was "probable" GST would apply to the award of damages, on the basis that the payment related directly to the supply of services.[55] The Federal Court in *Reglon Pty Ltd v FCT*[56] also indicated that it may in certain circumstances accept that a judgment was paid in consideration for a supply.

69. It is also important to note that the Commissioner does not include consent orders given consequential to a settlement deed in his definition of an award by a Court that is not subject to GST.[57]

70. The Commissioner describes how he applies GST to out-of-court settlements in GSTR 2001/4. In this ruling, the Commissioner describes three broad categories of 'supply' that might arise in the context of litigation:

(a) 'earlier supplies', which the Commissioner identifies as being a situation where the supply in question is actually the subject matter of the litigation;[58]

(b) 'current supplies', which are created by the settlement or judgment itself (for example, the transfer of property pursuant to the terms of the settlement or court order);[59] and

(c) 'discontinuance supplies', which arise as a consequence of litigation being discontinued (or not started) as part of a settlement.[60] These supplies cannot arise if the Court makes a decision.[61]

71. What the Commissioner seeks to do is to apportion GST towards each of the different types of supply and different times for supply, as well as towards any claim for damages.

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55 *Peet Limited v Richmond (No 2)* [2009] VSC 585. See also, *Moraghan v Cospak Pty Ltd* [2007] VSC 483, at [55].

56 [2011] FCA 805.

57 GSTR 2001/4, at [13].

58 GSTR 2001/4, at [45]-[47], [68].

59 GSTR 2001/4, at [48]-[49], [68].

60 GSTR 2001/4, at [50]-[55].

61 GSTR 2001/4, at [69]-[70].

In that regard, the Commissioner accepts reasonable dissection by the parties to a settlement, although his view is that in "most instances" the discontinuances supply will be ascribed no value.[62] The author notes that the Commissioner's approach ignores the inherent value of a discontinuance to litigating parties. The Commissioner's approach may also be inconsistent with the approach of the majority of the High Court in *Commissioner of Taxation v Qantas Airways Ltd* [2012] HCA 41, where the precise terms of the airline tickets issued by Qantas were examined in order to identify precisely the "supply" made for the purposes of the GST Act, despite those precise terms not aligning with the "essence, and sole purpose" of the acquisition of such tickets, being the provision of a flight.

72. That said, the Commissioner's approach to dismissing the value to be attributed to a discontinuance supply has been upheld by the Administrative Appeals Tribunal in *Lighthouse Financial Advisers (Townsville) Pty Ltd v FCT*.[63] In that case, the consideration of $200,000 paid to settle a breach of contract suit was concluded to be "for" the underlying damages claim, rather than the discontinuance of the suit. Consequently, no GST was leviable on the $200,000 and no input tax credit was claimable by the taxpayer.

73. The Commissioner also asserts the right to reapportion amounts between supplies if he considers that the parties' appointment is not reasonable.[64] The basis for this assertion is unclear. Further, allowing for the operation of the general anti-avoidance provisions, it is difficult to see how the Commissioner could re-apportion consideration to different supplies made between arms' length parties. It may be said that this approach seeks to replace the operation of the GST Act with the Commissioner's three categories (the Commissioner's definitions do not exist in the GST Act). Further doubt is cast upon the Commissioner's approach in the regard since, unlike his income tax ruling, GSTR 2001/4 is not wholly intended as a beneficial application of the law. Hence, no doubt, challenges will arise in due course.

74. Nonetheless, in advising on GST on a settlement, it is necessary to consider whether the settlement contains supplies in the three categories. In most cases, there will be no substantial difference in the GST outcome. The difficulty arises in identifying when the

62 GSTR 2001/4, at [107], [118].

63 [2014] AATA 301.

64 GSTR 2001/4, at [119].

Commissioner might disagree.

75. The GST Act contains specific provisions relating to insurance claims. Section 78-110 of the GST Act provides:[65]

> "If:
> (a) in compliance with a judgment or order of a court relating to:
> (i) a claim under an * insurance policy; or
> (ii) a claim by an insurer in exercising rights of subrogation in respect of an insurance policy; or
> (iii) a claim for compensation under a * statutory compensation scheme;
>
> an entity makes a payment of * money, makes a supply, or makes both a payment of money and a supply; and
> (b) had the payment or supply been made in the absence of such a judgment or order, it would have been a payment or supply made in settlement of the claim;
>
> the payment or supply is treated as having been made in settlement of the claim".

76. These rules are necessary because of the complex rules applying to insurers in meeting the payment of claims.[66] As a general rule, these are not a taxable supply to the recipient,[67] but may be to the insurer.[68] In *Millington v Waste Wise Environmental Pty Ltd*,[69] the Victorian Supreme Court (Croft J) held that damages to an insured party should be exclusive of GST.

Adjusting claims to allow for taxation

77. An increasingly common issue is whether, in drawing a claim, damages may be sought in respect of taxation liabilities that might arise from them. This is a question that has caused difficulties in the courts.[70] Hence, in *P M Sulcs & Associates Pty Ltd v Daihatsu Australia Pty Ltd*,[71] the New South Wales Supreme Court (Kirby J) stated:

> "In respect of the possible tax liability of the plaintiff for the amount awarded for the loss of a chance ($1,211,900) and the interest thereon, the plaintiff should have leave to apply for additional damages in the event of it being assessed as liable to pay tax on either or both of these amounts."

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65 See also, s 79-90 of the GST Act in respect of compulsory third party insurance schemes.

66 Division 78 of the GST Act.

67 Section 78-45 of the GST Act.

68 See, for example, s 78-65 of the GST Act.

69 [2015] VSC 167; see also *Fulton Hogan Constructions v Grenadier Manufacturing* [2012] VSC 358, at [468]; and *Gagner Pty Ltd v Canturi Corporation Pty Ltd* (2009) 262 ALR 691, at [147], [165] and [168].

70 See *Provan v HCL Real Estate Ltd* (1992) 24 ATR 238, (1992) 92 ATC 4644; *Tuite v Exelby* (1993) 93 ATC 4,293; *Rabelais Pty Ltd v Cameron* (1995) 95 ATC 4,552.

71 [2001] NSWSC 798, at [120]; see also *Jamieson v Westpac Banking Corporation*(2014) 283 FLR 286, at [230]; *Davinski Nominees v Bowler Holdings* [2011] VSC 220, at [58]; *Tomasetti v Brailey* (2012) 274 FLR 248, at [149].

78. However, that is an unsatisfactory conclusion, leaving a defendant open to additional claims until the period within which the Commissioner of Taxation is able to assess the taxation expires; it also leaves it open to the plaintiff to determine whether to dispute the assessment and, if not, raises questions about mitigation.

79. In the authors' view, a damages claim might properly include a component for a taxation liability where the behaviour sued upon has created a taxation liability that did not otherwise exist; or perhaps one which accelerated a taxation liability that would otherwise have been deferred in reliance on the *Gourley* principle established by the UK decision of *British Transport Commission v Gourley*.[72] Although such liabilities may be only contingent upon future events and valuations may be difficult to establish, they nevertheless may not be too remote. An example might be a suit in negligence of a pest inspector, resulting in a pre-CGT house being destroyed. Although damages for the loss of the pre-CGT asset would be tax free, they would not compensate the owners for the loss of their pre-CGT status when a replacement house was built post-CGT (although, note that for a replacement asset, it may be taken to have been acquired pre-CGT by section 124-85(3)). Also, the land on which the house is built will remain a pre-CGT asset. That might particularly be so, if the sale was contemplated in a rising market at about the time of the loss of the house. Of course, claims of this nature involve all of the difficulties inherent in any claim made for pure economic loss.

80. Of more concern to lawyers is that there is no doubt an obligation to include such claims, when appropriate. Unfortunately, to date there is no clear way to identify when this should occur.[73]

81. To highlight the uncertainty that can arise, in *FCT v Sydney Refractive Surgery Centre Pty Ltd*[74] the Court considered the position of a payout that had been reduced by 36% (the prevailing corporate tax rate) as a consequence of the recipient having received the payout by way of lump sum in place of what would otherwise have been assessable income receipts. The risk for the taxpayer was that the Commissioner would assess the income anyway – which he did do. Fortunately for the taxpayer the Full Court agreed the damages for defamation did not constitute income despite having been calculated by

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72 [1956] AC 185.

73 Indeed, Justice Gzell, writing extra-judicially has proposed that taxation should not be taken into account: *The Courts, Tax and Commercial Litigation* (2007) 81 ALJ 866, at pp. 879-880.

74 [2004] NSWSC 164.

reference to lost income.