Capital Gains Tax
Damages Award Implications of "Choses-in Action"!

Compensatory damages awarded by a court or settlements entered into by parties to litigation may be liable to Capital Gains Tax pursuant to Part IIIA of the *Income Tax Assessment Act* 1936, as amended (the "Act"), if the damages were awarded or settlements occurred after 24 June 1986.

There have been amendments to the definition of "asset" for the purposes of Part IIIA and accordingly, what constitutes an asset must be considered by reference to the dates the amendments took effect.

What is caught?

The legal adviser to parties to litigation who seek as relief an award of damages should attempt to ascertain whether those damages are likely to be:

(i) assessable income under s.25(1) of the Act; or
(ii) assessable capital gain under s.160Z0(1), if the "asset" involves a chose in action under Part IIIA s.160Z(a)(iii) of the Act: or
(iii) subject to the exemption provisions of the Act.

Is a "right to sue" liable to CGT?

The question whether a "right to sue" is an "asset" for the purposes of Capital Gains Tax - s.160A (a)(iii) - ie, a chose in action - has been dealt with in the main as regards Part IIIA of the Act since 24 June 1986 in the following cases:

(a) *Hepples v FCT* (1991-1992) 173 CLR 492 and 550;
(b) *FCT v Cooling* (1990) ATC 4472;
(c) *Provan v HCL Real Estate Pty Ltd* 24 ATR 238;
(d) *Tuite & Ors v Exelby & Ors* 25 ATR 81;
(e) *Carborundum Realty Pty Ltd v RAIA Archicentre Pty Ltd & Anor* 25 ATR 192;
(f) *Reuter v Federal Commissioner of Taxation* 111 ALR 716;
(g) *Namol Pty Ltd & Anor v A W Baulderstone Pty Ltd & Ors* 18 IPR 1; see also at 119 ALR 187.

If the chose in action arose on or before 25 June 1992, the matter is governed by the earlier definition of "asset" in S.160 - the chose in action will not be an asset. It is not a right of a proprietary nature, as was required under that earlier definition - see *Hepples* and *Cooling*. If, on the other hand, the chose in action/right to sue arose after 25 June 1992, it is clearly an "asset" as stated in s.160A (A)(iii) of the *Income Tax Assessment Act* 1936.

What should be done?

I would commend to fellow colleagues to address the issue of the exposure to a capital gains tax liability of any unresolved litigation commenced since 24 June 1986, but in particular, litigation commenced since the amendment to S.160A of the *Income Tax Assessment Act*, in respect to an "asset" dealt with after 25 June 1992. For the sake of caution, fellow colleagues should have their solicitors engage a qualified and experienced taxation adviser to advise whether Part IIIA of the Act in relation to any litigation in which a barrister is retained may give rise to a taxable capital gain. In so doing, they will be able to avoid potential exposure to a claim on their professional indemnity policy.

Barristers should ensure that, in relation to claims for damages, the pleadings include a claim as part of the damages the sum which may be the tax payable under Part IIIA of the Act. A claim should be made on behalf of a plain tiff for:

(i) a declaration of the liability of the other party or parties to the proceedings to pay the capital gains tax that would be incurred by reason of the plaintiff's success in the proceeding; and
(ii) an indemnity from the other party or parties to the proceedings in respect of that capital gains tax liability; or
(iii) an undertaking from the other party or parties to the proceedings to pay that capital gains tax liability.

Alternatively, consideration should be given to joining the Commissioner of Taxation as an additional party to the main proceedings such that any declarations as are made in relation to the Capital Gains Tax issue will be binding upon the Commissioner.

Also, when advising on the terms of settlement or form of minutes of orders, the exposure of the judgment to the capital gains provision of the Act should be taken into account and, if appropriate, an indemnity obtained from the other side.

In all matters, barristers should be aware that tax obligations may be being incurred because the effect of the transaction or arrangement may ultimately result in a capital gains tax liability to a party. Barristers should be alert to the possible capital gains tax implications of advice they given and communicate that to the client.

What is not caught?

The Act excludes transactions or actions involving "assets" that are <u>not</u> within the ambit of Part IIIA of the Act, namely:

(i) compensation or damages received in respect of personal injuries claims and defamation suits: s.160ZB(1);
(ii) receipts from winnings from bettings, lottery, gambling or other games of competition: s.160ZB(2);
(iii) insurance recoveries in the form of moneys received or replacement assets under a policy of insurance: ss.160ZZK and 160ZZL;
(iv) moneys received under other policies of insurance or policies of assurance: ss.160ZZH and 160ZZI. ❑

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