Capital Gains and Litigation

Bar News makes no apologies for dealing with the issue of Capital Gains Tax so frequently. Now the Commissioner of Taxation has issued a Ruling on the question. Michael Inglis, Blackstone Chambers, considers the implications.

Most clients think capital gains tax (CGT) has nothing to do with them. Most clients are wrong. This is as true with litigation as with other areas of legal practice.

I have been asked to provide a practical guide to the impact of CGT on litigation, from counsels' point of view. This I am pleased to do.

The subject is complex. So I have focused on three principal matters:

1. The choice facing counsel
2. The basic issues which arise
3. Further reading.

The Choice Facing Counsel

At the outset, counsel need to be clear on the scope of their retainer:

- Who is to advise the client as to the possible tax consequences (including CGT consequences) of the litigation ?
- Who is to advise the client (plaintiff) as to whether special relief should be sought in the originating process to cover the tax (CGT) effect on any judgment?
- Who is to advise as to whether settlement monies will be received free of tax, or be subjected to tax ?
- Who is to advise as to the *terms* of settlement, so that the monies will be protected from tax as far as possible?

Questions such as these require answers. For counsel to let the matter go by default, to say and do nothing, is to run considerable risks. The effect of CGT on compensation receipts (including damages and settlement monies) is now quite notorious.

There can be no legitimate assumption that - because the instructing solicitor, or client, do not raise the issue - counsel need not address it.

If counsel do not wish to accept responsibility for advising in this area, that should be made explicit.

If counsel do wish to accept responsibility, then counsel need to be very, very careful about what they are doing.

The basic issues which arise

Before CGT was introduced, with effect from 20 September 1985, much litigation was "an affair of capital". In the pre-CGT era, questions did arise as to whether litigation costs were deductible or not, whether so-called "undissected lump sum" receipts were received entirely free of tax, whether damages for loss of profits (or income) were fully subject to tax, and so on. There were also leading cases on the subject of whether the effect of tax should be taken into account in quantifying damages, both in respect of past and future years of income, and the year of income in which damages were received.

But, as a general principle, and subject to reasonably well-defined and well-known exceptions, litigants and their advisers could, and did, ignore the effect of tax in the institution of proceedings, and in obtaining judgment or proceeding to settlement.

Ever since 20 September 1985, the situation has been quite different. Because Australian CGT is, in essence, a tax on capital (gains), and because much litigation was previously "an affair of capital", it is perhaps not surprising that CGT has a profound effect on litigation: it was intended to do just that.

This whole subject - CGT and litigation - has been controversial for years. What has brought things to a head is the issue, late last year, of a Taxation Ruling by the Australian Taxation Office (ATO), giving the Commissioner's considered views on the subject: TR 95/35.

In light of TR 95/35, the effect of CGT on damages and settlement monies, in particular, cannot be ignored.

What Does the ATO Say?

Australian CGT is all about the DISPOSAL of ASSETS which were ACQUIRED on or after 20 September 1985. Where you have such a DISPOSAL of a post-CGT ASSET, then the possibility of a taxable CAPITAL GAIN or a CAPITAL LOSS arises.

Where the CONSIDERATION ON DISPOSAL exceeds the INDEXED COST BASE, or the COST BASE, as appropriate, of an asset, a CAPITAL GAIN accrues.

Just about everything you can imagine in Australian CGT has a special (defined) meaning. The whole of CGT is an artificial construct, replete with deeming provisions: for example, if a taxpayer disposes of an asset and there is no actual CONSIDERATION ON DISPOSAL, the CGT provisions *deem* the taxpayer to have received the full market value of the relevant asset subject, as you would expect, to certain (very limited) exceptions.

CGT has it own timing rules, both for acquisitions and disposals. With corporate taxpayers (and trusts) a change in "beneficial interests" can deem the fresh (post-CGT) acquisition of assets actually acquired before CGT.

What the ATO says, in light of these extensive definitional, deeming and operative provisions, is that:

1. The right to seek compensation (including the *right to sue*) is an "asset" for CGT purposes, and has been such ever since 20 September 1985.
2. The right to seek compensation (including the *right to sue*) is acquired at the time the damage, monetary loss or injury occurs.
3. The obtaining of judgment, or the settlement of an action, is a disposal of the relevant asset, being the right to sue.
4. The cost base of the right to sue (to the plaintiff) may include legal fees and charges connected with the proceedings and incurred during the course of proceedings. It does *not* include any deemed market value of the right to sue. It may include other money,

property, or money and property paid or given in respect of the acquisition of the right to sue if there is some direct and substantial link between the money or property and the acquisition of the right to sue.

5. The consideration on disposal of the right to sue is the amount ordered to be paid by the Court, or the settlement monies obtained.

These views of the ATO have been widely accepted as a proper interpretation of the CGT provisions.

If these were the only principles, the effect would be catastrophic, making most damages and settlement receipts directly subject to CGT.

There are two main limiting factors. *First*, the CGT provisions (in Part IIIA of the *Income Tax Assessment Act* 1936) contain an express exemption:

"160ZB(1) 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 a wrong or injury, shall be taken to have resulted in the taxpayer having incurred a capital loss."

The precise scope of this exemption is a subject in itself. The two most common cases within s160ZB(1) are compensation or damages for personal injury, and for defamation. As to the former, the ATO has this to say in paras 214-217 of TR 95/35:

214. We consider that the terms 'to his or her person' and 'in his or her vocation' should be read as widely as possible to cover the full range of employment and professional type claims, and include claims for discrimination, harassment and victimisation (or any directly related claims) arising out of State and Commonwealth anti-discrimination legislation, and wrongful dismissal.

215. We have considered the potential width of the exemption in Taxation Determinations TD 14 and TD 92/130. TD 14 considered payments made under accident and health assurance policies, while TD 92/130 considered payments of compensation amounts for defamation, for loss of support following wrongful death, and for the professional negligence of a solicitor in failing to institute personal injury claims. Draft Taxation Ruling TR 94/D20 also considers compensation for personal injury and makes it clear that damages in this context are generally received for the loss of earning capacity (and for claims such as future care costs) rather than for loss of income. In all of these circumstances the exemption provided by subsection 160ZB(1) applies.

216. Compensation for any wrong or injury suffered by a company does not fall within the scope of the exemption. We consider that the use of 'his or her' in connection with the taxpayer suggests that the application of subsection 160ZB(1) is intended to be limited to taxpayers who are natural persons. Similarly, we consider that compensation received by a trustee in his or her capacity as trustee does not fall within the scope of subsection 160ZB(1). Of course, amounts received by the trustee in respect of the surrender of a personal injury claim of the trustee continue to be exempt.

217. Exemption under subsection 160ZB(1) is also available for an undissected lump sum compensation amount which is received by a taxpayer wholly in respect of the personal injury of the taxpayer. Refer to paragraph 207 of this Ruling."

Two other important elements of TR 95/35, in this regard, are as follows:

3. For the purposes of this Ruling the following terms are used:

Undissected lump sum compensation receipt

An undissected lump sum compensation receipt is any amount of compensation received by the taxpayer where the components of the receipt have not been and cannot be determined or otherwise valued or reasonably estimated.

...

207. Of course, if the taxpayer can show that all of the separate heads of claim relate to the personal injury of the taxpayer, and that there are no other non-personal injury elements of compensation within the total claim, the exemption under subsection 160ZB(1) continues to apply to the compensation.

208. It is likely that some information is available when a compensation claim is made which can be used to dissect a lump sum amount of compensation. Alternatively, the components of the lump sum ordinarily are able to be estimated or valued on a reasonable basis.

209. The principles relating to the assessability of dissected and undissected amounts apply equally to lump sum compensation amounts received for personal injuries claims, whether by way of settlement or under a Court order."

These are selected passages only, and any counsel interested in the s160ZB(1) exemption, needs (as a starting point) to become familiar with the terms of TR 95/35 *as a whole*.

The second limiting factor is that the ATO has adopted a "look-through" approach in TR 95/35, essentially an analysis of all the possible assets of the taxpayer in order to determine the asset to which the compensation amount is most directly related. This approach is also called the "underlying asset" approach.

Disposal, for CGT purposes, includes the loss or destruction (in whole or in part) of an asset: s160N. So where you have an underlying asset, such as a building, which is partially destroyed due to the negligence of a lorry driver, the ATO is prepared to relate the damages, the settlement monies, or the insurance proceeds, to the *underlying* asset, the building. The immediate (or intermediate) asset - being the right to sue - is effectively ignored for CGT purposes. The CGT

consequences are determined by reference to the underlying asset's partial destruction (and partial disposal), its date of acquisition, its cost, any available roll-over relief, and other relevant factors.

Paragraph 29 of TR 95/35 contains this outline of the Ruling:

A Actual disposal of the *underlying asset.*
Includes a disposal of part of the *underlying asset.* This also includes loss or destruction of part or all of the underlying asset. The taxpayer uses the general disposal provisions of Part IIIA, including any roll-over relief and exemption.
Sections 160M and 160N

B No disposal of the underlying asset; *permanent damage* to, or *permanent reduction* in the value of, the underlying asset.
This requires a reduction of the total acquisition costs for so much of the amount received as represents compensation for the permanent damage or permanent reduction in value.
Subsections 160ZH(11) and 160ZD(4) (dissection basis)

C No disposal of the underlying asset; disposal of the *right to seek compensation.*
Consider this under the general disposal provisions. In some cases an exemption may be available.
Section 160A (pre and post-amendment), subsection 160M(6) (post-amendment), paragraph 160M(3)(b) and subsection 160ZB(1)

D Act, transaction or event not covered by A, B, or C.
Subsection 160M(7) will apply.
Subsection 160M(7) (pre and post amendment)"

TR 95/35 is 80 pages long. It contains *pages* of definitions. Each of the four cases (A-D) can produce significant CGT consequences. Each of the four cases is dealt with at length in the Ruling.

In the nature of things, it is case C (No disposal of the underlying asset; disposal of the *right to seek compensation*) which will prove of greatest concern in the litigation area. This is where personal injuries claims fit in, and where the s160ZB(1) exemption (when available) is so valuable.

Over the years, various plaintiffs have been concerned at the prospect of CGT being payable on their damages, and have sought relief from the Courts. Some judges have been prepared to grant relief, a number have not. It will be interesting to see how things develop now, in light of the ATO's considered views as expressed in TR 95/35.

The relief granted by the Courts has included the following:

- Indemnity against possible CGT liability, on conditions: *Provan v HCL Real Estate Limited* (1992) 92 ATC 4644
- Increase in damages to compensate for probable CGT, on conditions: *Tuite v Exelby* (1993) 93 ATC 4293
- Liberty to apply to have any CGT liability (if assessed) included in the claim for damages: *Rabelais Pty Ltd v Cameron* (1995) 95 ATC 4552.

At the end of the day, CGT cannot be ignored in litigation. Clients deserve to be told what they will receive from the litigation *in after-tax dollars*, as best that can be estimated.

Clients don't like surprises. If they expect to receive damages (or settlement monies) free of tax, and they don't, then they will not be happy. They might even sue.

FURTHER READING

CGT does not stand still. Indeed, as a new and significant area of law, CGT law and practice is growing at an astonishing rate. In recommending some further reading, I particularly emphasise that any counsel wishing to accept responsibility for advising in this area needs to master the subject of "CGT and Litigation" and then keep up to date. Counsel might care to read:

- Taxation Ruling TR 95/35 (Income tax: capital gains: treatment of compensation receipts), issued 6.12.95 by the ATO.
- NSW Bar Association CLE Seminar Paper "Taxation of Judgments Awards and Settlements" (9.10.95) by A H Slater QC and J W Durack SC.
- The Taxation Determinations and Draft Taxation Rulings referred to in TR 95/35 (see, for example, para 215 quoted above).
- The huge CGT literature available in this country, published by CCH Australia Ltd, The Law Book Co, The Taxation Institute, and others. ❑

ADDENDUM: CGT is a tax of last resort. It applies in circumstances where (or to the extent to which) income tax in the ordinary sense is not payable. So, as a practical matter, it is always desirable in the first instance to ask whether the relevant damages or settlement monies are assessable to income tax in the ordinary sense. CGT is important but it is not the only consideration.

On 5 June 1996 the ATO issued PRE-RULING CONSULTATIVE DOCUMENT No 10 (PCD 10) on the following topic: " Income tax: how are compensation or damages payments for personal wrong and injury treated under sub-section 25(1) and paragraphs 26(e) and 26(j) of the *Income Tax Assessment Act* 1936?"

This is an exceedingly important document and, despite its preliminary nature, deals with the assessability or otherwise of, for example, periodical receipts of workers' compensation and commutations of periodic workers' compensation receipts into a lump sum amount. As to the latter, the ATO has this to say:

" We do not consider that a commutation of the income stream results in the amount losing its identity as income ..."

PCD10 will be followed by a Draft Taxation Ruling and then a final Taxation Ruling. For anyone interested in the taxation treatment of compensation or damages payments for personal wrong and injury, PCD10 is a vital document. ❑

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