

## CIVIL LITIGATION AND TAXATION: THE PLAINTIFF

The intention of this article is to examine a matter of perennial interest in civil litigation: the taxability of litigation recoveries and settlement payments. The article seeks not only to revise an earlier study on this topic<sup>1</sup> but also to provide non-tax specialists with sufficient background to advise clients of the best form of recovery, at least from the income tax point of view. The subject to be discussed is a relatively narrow one; we are concerned only with recoveries by successful plaintiffs or claimants. Other important issues, and especially the deductibility by a defendant or obligor of a judgment or settlement payment, and the deductibility of legal expenses and fines, will be examined in a later study.

It is obvious even to the lawyer to whom tax is anathema, that the economics of a recovery must be affected by a decision that it will be included within assessable income. Substantial tax savings, for example, may be achieved through averaging procedures, that is, by preventing the entire amount becoming assessable in the one tax year and thus attracting high marginal rates, or by converting the income receipt into capital through an alienation procedure.

### 1. General Principles

The Income Tax Assessment Act, 1936-1977 (Cth.), (hereafter referred to as "the Act") has no one comprehensive provision on the tax treatment of litigation recoveries. Two specific provisions deal with recoveries by victims of fraud and embezzlement<sup>2</sup> and by landlords from tenants who have breached covenants to repair.<sup>3</sup> It falls to the general income provision, s.25(1), and to the indemnity and insurance provision, s.26(j), to determine the taxability of all other recoveries.

#### (A) S.25(1): ORDINARY INCOME

S.25(1) simply provides that assessable income shall include the gross income from certain sources, depending upon the taxpayer's residential status. As any tax student knows, this section does little more than define "income" by saying that it is income, yet it is to this section that, by default, our attention shall be mainly directed. It is submitted that the cases have, under the umbrella of this provision, established a general principle that a litigation recovery will be taxable in a plaintiff's hands if, and only if, it would have been assessable income had it been paid without any wrongful act of the defendant. In this respect the courts and boards have functionally, if not always expressly, examined the *source* of the recovery. Where the recovery is a consequence of damage to a taxpayer's capital assets it is characterised as a capital replacement. On the other hand, a recovery for a loss of income will be treated as a replacement of income and hence will be assessable. The *source* principle simply follows from the proposition that "moneys recovered from any source representing items on a revenue account must be regarded as received by way of

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1. Marks, *Tax Treatment of Litigation Recoveries and Settlement Payments* (Taxation Institute of Australia, 1975). Certain parts of that study are included as background.

2. S.26(k).

3. S.26(l).

revenue".<sup>4</sup> Later parts of this article will examine this principle's practical application.

(B) S.26(j): INSURANCE AND INDEMNITY

The insurance and indemnity provision might at first reading be regarded as one which comprehensively deals with all litigation recoveries. S.26(j) charges to assessable income "any amount received by way of insurance or indemnity for or in respect of any loss . . . (ii) of profit or income which would have been assessable income if the loss had not occurred . . ."<sup>5</sup> This provision has now been the subject of a considerable amount of litigation both at the court and board level and, it is submitted, the following propositions are established:

1. S.26(j) does not make assessable any recovery which, apart from the section, would not be assessable. Clearly, a damages award or settlement payment for the destruction of a capital asset would not come within the section since such damages would not be of an income nature.<sup>6</sup>

2. The word "indemnity" has been interpreted relatively widely to encompass virtually all compensation for loss or damage. Probably the more usual meaning of this term would require the section to be read down to recoveries under a contract since, in its strict sense, indemnity refers to a contractual security against contingent losses. Indeed, a 1942 decision under Queensland income tax legislation supports this view.<sup>7</sup> But in *Federal Commissioner of Taxation v. Wade*<sup>8</sup> the High Court applied a broader definition; it was said that the term "by way of . . . indemnity" described the character of the receipt. The Court there held that a compensation payment by a statutory authority to a dairy-farmer for the compulsory destruction of diseased cattle was an "indemnity" within the section. The decision in *Wade* was seized upon by other judges to extend the definition further. For example, Gavan Duffy J. in *Robert v. Collier's Bulk Liquid Transport Pty. Ltd.*<sup>9</sup> treated the word "as covering compensation for loss or damage",<sup>10</sup> and thus held taxable under s.26(j) damages for loss of profits arising from damage to a plaintiff's semi-trailer. There is now considerable support for the view that all damages in tort for loss of profits are amounts received by way of indemnity.<sup>11</sup>

4. *Federal Commissioner of Taxation v. Wade* (1951) 84 C.L.R. 105, 112; 9 A.T.D. 337, 341 per Dixon and Fullagar JJ.

5. S.26(j) reads as follows:

"any amount received by way of insurance or indemnity for or in respect of any loss —

(i) of trading stock which would have been taken into account in computing taxable income; or

(ii) of profit or income which would have been assessable income, if the loss had not occurred, and any amount so received for or in respect of any loss or outgoing which is an allowable deduction."

6. Cf. *Glenboig Union Fireclay Co. Ltd. v. I.R.C.* [1922] S.C. 112; 12 T.C. 427; 4 T.B.R.D. Case D85/4 C.T.B.R. (N.S.) Case 7 (No. 1 Bd., 1953).

7. *Coolangatta Electric Supply Co. Ltd. v. Commissioner of Taxation (Qld.)* [1943] Qd. S.R. 77; 7 A.T.D. 108 (Ct. of Review).

8. (1951) 84 C.L.R. 105; 9 A.T.D. 338.

9. [1959] V.R. 280.

10. *Id.*, 283.

11. See *Williamson v. Commissioner for Railways (N.S.W.)* [1960] S.R. (N.S.W.) 252; 76 W.N. (N.S.W.) 648; *Winkie Meat Works v. Ballard* [1960] S.A.S.R. 312 (F.C.); *Groves v. United Pacific Transport Pty. Ltd.* [1965] Qd. R. 62; *Lonie v. Perugini* (1977) 77 A.T.C. 4318; 7 A.T.R. 674 (S.A. F.Ct.). In *Allsop v. Federal Commissioner of Taxation* (1964) 113 C.L.R. 341; 14 A.T.D. 62 the High Court held that a release of a claim against a State government for a refund of

3. S.26(j) has no application to a component of an award of damages which compensates for an *anticipated* loss of profits or income. It will be seen that the cases have established a *prima facie* rule that awards of damages for the loss of past income, such as the loss of salary or profits up to the date of a trial, are assessable as ordinary income. The contentious issue has traditionally been whether an award for the loss of *future* income, that is, from the date of trial or judgment, is capital or income. An enthusiastic Commissioner might have thought that s.26(j) would have covered this problem and thus the resolution of the issue under s.25(1) might be irrelevant. The courts, however, have not been prepared to read the section in this way. For example, Crawford J. in *O'Keefe v. Ellis*<sup>12</sup> stated:

“as to damages to future economic loss, I hold that the section is not applicable . . . The tenses used lead to this conclusion—in respect of any loss of profit or income which *would have been* assessable income if the loss had not occurred’.”<sup>13</sup>

Crawford J.'s opinion was examined and accepted by two of the three judges of the South Australian Full Court in an important recent decision, *Lonie v. Perugini*.<sup>14</sup> King J. there assumed that the thrust of the section is that it deals with a loss, which had already occurred, of profit or income which would already have been assessable income. He said that, although it was possible to read the provision as making assessable indemnities for loss of future profits, to do so would be “to strain language”.<sup>15</sup> Hogarth J. agreed and supported his conclusion by a careful analysis of the individual words and phrases of the section. He said that the past participle “received” refers “to an amount which could be so described at the time of the making of the relevant taxation assessment”.<sup>16</sup> Secondly, although the compound verb in the phrase “*would have been* assessable income” does not indicate the time to which it relates, the timing is fixed by the following conditional clause “if the loss *had not occurred*”. He commented:

“This is the use of the pluperfect tense. Its grammatical use is to describe an action (or state) which was already past when viewed from the standpoint of some other past event. Here it means, I think, that when viewed from the receipt of the damages, they related to a loss which had already occurred.”<sup>16a</sup>

Thirdly, and as a result, His Honour said that “loss” was the deprivation of moneys which would have been assessable income as and when the deprivation occurs:

“So it is the deprivation of income which must have already occurred when looked at from the standpoint of the time when the damages are received, either actually or notionally in the form of a judgment.”

11. (Continued)

illegally collected highway transport permit fees was not an indemnity. See further 69 A.T.C. Case A82/15 C.T.B.R. (N.S.) Case 60 (No. 2 Bd., 1969) where an adjustment of rates and land tax allowed to a vendor of land was held not to be an indemnity.

12. [1961] Tas. S.R. 169.

13. *Id.*, 172-173.

14. (1977) 77 A.T.C. 4318; 7 A.T.R. 674.

15. 77 A.T.C. 4318, 4331; 7 A.T.R. 674, 688.

16. 77 A.T.C. 4318, 4327; 7 A.T.R. 674, 683.

16a. *Ibid.*

Finally, Hogarth J. hinted that the exclusion of future losses from the ambit of s.26(j) was perhaps illogical and could easily have been achieved by rewording the provision, but that "we must take the section as we find it".<sup>16b</sup>

Bray C.J., who dissented, took a grammatically less stringent approach to the wording of revenue legislation:

"Neither, I think, in ordinary speech or under the rules of English grammar does the use of the perfect conditional in the phrase 'which would have been assessable income', or the use of the pluperfect in the phrase 'if the loss had not occurred' restrict the application of these phrases to a time before the occasion on which they are used or to which they are applied. When in an ordinary personal injury case we speak of the money which would have been earned by the plaintiff if the accident had not occurred we are not speaking only of past lost hypothetical earnings as at the date of trial, but also of future lost hypothetical earnings thereafter. When a judge uses such phrases, as judges frequently do, he is certainly not restricting himself to the earnings lost before the trial. The perfect and pluperfect tenses in such cases are used to denote something which would, but for the relevant event, have happened before some future date, as well as something which would, but for that, have happened before the date on which the phrases are spoken or written."<sup>17</sup>

4. Consequently, s.26(j) has little effect in taxing litigation and settlement recoveries: it merely leads to a rather unhelpful statement of an obvious principle, *viz.* that assessable income includes compensation for or in respect of any accrued loss of assessable income. Nor does the s.26(j) provide any indicia as to what compensation for past losses will be assessable income or capital receipts.

**(C) TAX POLICY AND TAXATION OF DAMAGES: THE ONCE-AND-FOR-ALL RULE AND TAX ACCOUNTING**

It is probably useful at this point to identify one important factor which may influence the courts in determining whether a particular compensation recovery is to be treated as a taxable or a capital receipt: it results from the joint operation of damages principles and a rule of tax accounting. The basic tax accounting rule in the Act is that tax is levied "upon the taxable income *derived* during the year of income by any person" (s.17). "Derived" means "obtaining", "getting", or "acquiring"<sup>18</sup> as well as any dealing with income on behalf of a taxpayer (s.19). A cash basis plaintiff who receives the proceeds of a judgment or settlement as income or an accruals basis plaintiff who is entitled to receive such proceeds is, then, assessable on the entire judgment. A judgment, however, is not a continuing affair: the once-and-for-all rule requires all recoveries to be in a lump sum form.<sup>19</sup> In awarding damages a court compensates the plaintiff for all injuries—past, present and future—in the one award; in this process the court will attempt to capitalize future losses by applying appropriate discount

16b. *Ibid.*

17. 77 A.T.C. 4318, 4323; 7 A.T.R. 674, 679.

18. *Cf.* Isaacs J. in *Federal Commissioner of Taxation v. Clarke* (1927) 40 C.L.R. 246, 261.

19. *Fournier v. Canadian Pacific Rwy. Co.* [1927] A.C. 167 (P.C.); *Pammant v. Pawelski* (1949) 79 C.L.R. 406 (H.C.). See generally Luntz, *Assessment of Damages for Personal Injury and Death* (1974), 13-21.

rates.<sup>20</sup> The combined effect of the once-and-for-all rule and s.17 is that a lump sum income award for losses of all income, past, present and future, enters into the plaintiff's assessable income net in the one tax year, even if it represents, say, loss of profits for a period of 20 years. While the present real value of the future loss of income may be considerably less than the income which the plaintiff would have been expected to receive over the 20-year period (since it is capitalized), it will, if it is assessable, be for tax purposes "bunched" and may thus attract high marginal rates which would not otherwise be applicable (if it could have been "averaged" over the 20 years). It is suggested that the hardship of bunching may provide a strong policy factor against the characterizing litigation recoveries as income in borderline cases. King J. in *Lonie v. Perugini* was, for example, clearly influenced by this factor:

"I would not wish to strain language to hold that compensation which a taxpayer receives for future loss of income is taxable in the year of receipt (as it must be if it is taxable at all) and therefore at a rate which might be far higher than if the income were received in the ordinary course of a period of years."<sup>21</sup>

This policy, however, may change quite significantly where, as in South Australia and Western Australia, the lump sum award principle may be replaced by a system of continuous assessment and periodical compensatory payments;<sup>22</sup> it would be expected that recoveries in these States in the form of recurrent payments would, *prima facie*, be assessable.<sup>23</sup>

#### (D) BRITISH TRANSPORT COMMISSION v. GOURLEY

An important civil litigation issue which is related to but separate from the topic under discussion is the rule in *British Transport Commission v. Gourley*.<sup>24</sup> This rule requires that the capitalization of lost future income be reduced to take into account the non-assessability to tax of the recovery where, had the plaintiff not been injured, tax would have been assessable on the future income as it was derived. The tax set-off, of course, only applies where the recovery is not taxable. It is a strange feature of our judicial and tax system that this issue must be decided without the assistance of the revenue authorities and before any receipt, whether of income or capital. The *Gourley* problem is in practice decided before the tax issue (between the Commissioner and the plaintiff) arises. But for our purposes *Gourley* is merely secondary: the concern of this article is whether a plaintiff—or a judge—should regard the award as assessable income. Most importantly, too, our concern is also a post-*Gourley* matter: how, in fact, will the award be treated under the Act.

20. For the method of discounting for present value see *Beneke v. Franklin* [1975] 1 N.S.W.L.R. 571 (C.A.) (appeal to High Court dismissed, 8th December, 1975 (unreported)).

21. (1977) 77 A.T.C. 4318, 4331; 7 A.T.R. 674, 688.

22. Supreme Court Act, 1935-1975 (S.A.), s.30b; Motor Vehicle (Third Party Insurance) Act, 1943-1976 (W.A.), s.16. See generally Luntz, *op. cit. (supra, n.19)*, 21-26; Marks, *op. cit. (supra, n.1)*, 12-13.

23. Receipts of a current nature are more likely to be, but not necessarily will be, treated as income rather than capital: *Egerton-Warburton v. Federal Commissioner of Taxation* (1934) 51 C.L.R. 568; 3 A.T.D. 40; *Just v. Federal Commissioner of Taxation* (1949) 8 A.T.D. 419; 4 A.I.T.R. 185; *Federal Commissioner of Taxation v. Dixon* (1952) 86 C.L.R. 540; 10 A.T.D. 82; 5 A.I.T.R. 443. The presumption, however, may be rebutted: 70 A.T.C. Case B79/16 C.T.B.R. (N.S.) Case 28 (No. 3 Bd., 1970).

24. [1956] A.C. 185 (H.L.).

*Gourley* is now well entrenched in Australia; it applies to awards for loss of salary and for other profits, from torts and breaches of contract and covenants, where it can be expected that the recovery will not be assessable.<sup>25</sup> Yet *Gourley* is a two-edged sword and the courts have now accepted that the capitalization of lost future profits involves an increasing factor to take into account the tax liability on the interest expected to be received on the investment of the lump sum recovery.<sup>26</sup> It is not intended to discuss this rule here, but at least one difficult question, with its converse, should be raised for some other commentator. Where a judge makes an award which he assumes will not be taxable and a *Gourley* set-off is applied and, after the court is *functus officio*, the award is properly determined to be taxable in proceedings with the Commissioner, how does the plaintiff make up his now inadequate compensation? On the other hand, a recovery which is assumed to be taxable (and for which no tax set-off is applied) might be a matter for concern for a defendant or his insurer—if the Commissioner does not assess it as taxable. The second question is easier to answer than the first since, unless the plaintiff told the defendant, he would never know of the plaintiff's windfall. But the first question points to yet another of the many faults with the lump sum once-and-for-all compensation system. Under a system of periodic compensation payments the tax issue could be reviewed on a yearly basis; and, should the court incorrectly assume that the award is non-taxable (and hence to be subject to a *Gourley* set-off) later payments could be increased to take the taxation into account.<sup>27</sup>

#### (E) APPORTIONMENT

Another general principle to consider is the problem of dissection of lump sum recoveries which compensate for both losses of assessable income and capital.<sup>28</sup> In most cases, and especially where the claims are for unliquidated amounts, it will be impossible to identify what portion of the recovery is for loss of income (and thus assessable) and what portion for loss of capital. The authorities point to a rule that only where the parties or the judge provides a basis for apportionment will the revenue be able to assess any of it; there must, then, be some reasonable basis for apportionment. Naturally a plaintiff, *vis-à-vis* the Commissioner, will attempt not to provide that basis.

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25. *National Insurance Co. of New Zealand Ltd. v. Espagne* (1961) 105 C.L.R. 569; *Black v. Mount* [1965] S.A.S.R. 167; *Hamlyn v. Hann* [1967] S.A.S.R. 387 (F.C.); *Bitolas v. Tsakonakas* [1972] S.A.S.R. 416; *Beneke v. Franklin* [1975] 1 N.S.W.L.R. 571 (C.A.); *Lonie v. Perugini* (1977) 77 A.T.C. 4318. In *Melbourne Saw Manufacturing Co. Pty. Ltd. v. Melbourne & Metrop. Board of Works* [1970] V.R. 394, *Gourley* was applied to a claim under the Town and Country Planning Act, 1961-1969 (Vic.), for loss of profit suffered by an owner of land by virtue of the operation of a metropolitan planning scheme. Reported cases where *Gourley* was not applied (since damages were assumed to be taxable) are *Williamson v. Commissioner for Railways (N.S.W.)* (1959) 60 S.R. (N.S.W.) 252 (fire resulting in loss of sheep and lambs and diminution in quality of wool) and *Winkie Meat Works Ltd. v. Ballard* [1960] S.A.S.R. 312 (F. Ct.) (loss of profits caused by defendant's breach of covenant in restraint of trade).
  26. *Taylor v. O'Connor* [1971] A.C. 115 (H.L.); *O'Brien v. McKean* (1968) 118 C.L.R. 540; *McCoy v. Johnson* (1972) 3 S.A.S.R. 187; *Sunderland v. Maccopalmer* (1972) 3 S.A.S.R. 314; *Hawkins v. Lindsley* (1974) 49 A.L.J.R. 5; *Beneke v. Franklin* [1975] 1 N.S.W.L.R. 571 (C.A.).
  27. *Cf. Musca v. Colombini* [1971] W.A.R. 33 (F. Ct.) where the court indicated that an order for periodic payments could be increased upon assessment to tax.
  28. See generally Marks, *op. cit.* (*supra*, n.1), 42-48.

The seminal decision is *McLaurin v. Federal Commissioner of Taxation*.<sup>29</sup> There a dairy-farmer recovered lump sum compensation for damages caused by a fire which originated on land owned by the New South Wales Commissioner for Railways and which spread to the farmer's property. The farmer claimed £30,000 for both property damage and loss of profits. The Railways Commissioner negotiated a settlement of £12,350: this amount had been suggested to the Commissioner on the advice of a valuer who had compiled a list of the particulars of damage. The Federal Commissioner of Taxation sought to assess a major part of the recovery (£10,600). The Full High Court refused to allow any apportionment (and hence none of the amount was assessable) since the valuer's report had never been revealed to the farmer. The fact that the revenue was able to make a "confident guess" as to the worth of the farmer's claims (and thus apportion the lump sum between income and capital) was irrelevant. In a joint judgment Dixon C.J., Fullagar and Kitto JJ. stated:

"It is true that in a proper case a single payment or receipt of a mixed nature may be apportioned amongst the several heads to which it relates and an income or non-income nature attributed to portions of it accordingly . . . But while it may be appropriate to follow such a course where the payment or receipt is in settlement of distinct claims of which some at least are liquidated . . . or are otherwise ascertainable by calculation . . . it cannot be appropriate where the payment or receipt is in respect of a claim or claims for unliquidated damages only and is made or accepted under a compromise which treats it as a single, undissected amount of damages. In such a case the amount must be considered as a whole . . ."<sup>30</sup>

The 1975 Full Report of the Commonwealth Taxation Review Committee (the Asprey Committee) has recognised the tax planning implications flowing from *McLaurin*, and it is likely that the Commissioner will be given a discretionary power to make his own proration, since the "law as it stands might be thought to encourage practices in the settlement of claims to compensation . . . that will defeat the Revenue."<sup>31</sup>

#### (F) SETTLEMENT OR RELEASE?

Finally, a procedural tactic which might influence the tax treatment of out-of-court settlements should be mentioned. Where the parties are able to reach out-of-court agreements, counsel might consider the difference between a settlement or discharge of the claims, on the one hand, and the release or withdrawal of the same claims, on the other. This difference might, from a tax point of view, appear to be one merely of form. The recent trend in s.260 cases, however, has now clearly pointed out the importance of form in tax rulings.<sup>32</sup> It is suggested that a recovery paid in consequence of a release or withdrawal might lead to a capital receipt in cases where the same recovery paid as a result of a settlement or a discharge might produce, to the recipient, assessable income. Support for this distinction comes from two relatively old English decisions.

In *Du Cros v. Ryall*,<sup>33</sup> a 1935 first instance decision, the taxpayer, who was general manager of a large company, alleged that he had a

29. (1961) 104 C.L.R. 381 (Full H.Ct.).

30. *Id.*, 391.

31. Para. 7.101.

32. See generally Grbich, "What the Three Sisters Did to Section 260", in Monash Univ./Tax Inst. of Aust., *Recent Developments in Taxation Law* (1977), 1.

33. (1935) 19 T.C. 444.

15-year service agreement with the company at a fixed salary, a right to commission, and a right of succession to the managing directorship. After five years the company repudiated the agreement and dismissed the taxpayer. He sued for accrued salary, commission, and wrongful dismissal. The company's defence was that the agreement was not binding at all. The matter was eventually settled and the taxpayer received compensation of £57,250. He *released* the company from all claims and demands "whether already accrued, accruing or hereinafter to accrue or arise" and further agreed that the service agreement was cancelled. The revenue authorities then apportioned the £57,250 and sought to assess £27,500 of it on the basis that it was for lost commission, that is, lost profits; it was accepted that the other portion was not assessable since it was characterized as damages for breach of the employment contract. Finlay J. held that the revenue was not entitled to go beyond the form of release and that there was no material upon which any apportionment could be based. His Honour held that in these circumstances he would not treat any part of the damages as being paid in respect of lost commission: the damages had to be regarded as a whole—and as a capital sum.

In 1946 the Court Appeal distinguished *Du Cros* in *Carter v. Wadman*.<sup>34</sup> There the taxpayer's contract of employment entitled him to a salary and share of profits. At the time he was wrongfully dismissed he was owed a share of accrued profits. He accepted a lump sum compensation "in full settlement of all past, present and future claims". The revenue apportioned the payment in the way most favourable to them: they estimated the lost profits and subtracted this amount from the total: whatever was left was not assessable, being for breach of the employment contract. The Court of Appeal held that some form of apportionment of the lump sum was permissible even though no basis for it appeared in the settlement documentation. However, the apportionment was to be fairer and an estimate of the value of the assessable claim (the lost profit) and the non-assessable claim (for the contract breach) was to be obtained, from which a percentage of the lump sum could be then calculated to represent the compensation for the income producing claim. The Court of Appeal did not explain why it was departing from the clear statement of principle in *Du Cros*, but it suggested briefly that there would have been no apportionment had the plaintiff, in receiving the compensation, released or withdrawn his claims, rather than accepting the compensation for a discharge of settlement of claim. The judge at first instance, Atkinson J. more fully explained the distinction between *Du Cros* and *Wadman*. He said:

"... in the *Du Cros* case, it was a payment which was described as damages for the repudiation of the agreement. The terms of the release show that the claims were not settled or discharged in any way, but that there was a complete release from all claims. In other words, the claims were withdrawn. If a sum is paid by way of damages for repudiation of an agreement, and the claims, whether they were good, bad or indifferent, were withdrawn, and there was no suggestion that the agreement was not a bona fide representation of the real bargain, it is very difficult to see that any part of the ... damages ought to be deemed to be paid in discharge of the

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34. (1946) 28 T.C. 41.



claims which had been withdrawn. This is the main difference between *Du Cros* and this case."<sup>35</sup>

## 2. Personal Injury Awards

The unresolved tax issue with personal injury recoveries remains whether or not compensation which relates to loss of wages or profits up to the date of trial is to be treated as assessable income or capital. There has certainly been no move in the last three years to assess personal injury awards for pain, suffering, loss of amenities, loss of expectation of life, or disfigurement. Nor has any recent case raised the issue of assessability of recoveries for future loss of earnings: such lump sum recoveries are characterized in terms of *loss of earning capacity* and treated as a replacement of a loss of a capital asset—the ability to earn—rather than as recoveries for loss of earnings (which would be assessable as a replacement of an income source).<sup>36</sup> The capital nature of personal injury/future income recoveries must now be beyond dispute even though no policy argument has been raised to support such a principle. The contrary argument, to the effect that these recoveries should be assessable, still remains: the damages are linked to, and calculated on the basis of, an income source in the same way as a recovery for a loss of profits is linked to a business source.

It can be expected, however, that the Commissioner might in the future attempt to assess certain lump sum recoveries for loss of future income in the hands of injured employees. Where an employee is permanently disabled there may be strong emotional reasons to exclude a damages recovery from assessability,<sup>37</sup> but an employee who is merely temporarily disabled, say, for six months, might be in a different position. There is already strong judicial authority for the assessability of future income recoveries for temporary disabilities. For example, Gale J. in the Ontario Supreme Court has said:

"It is by no means clear . . . that damages for temporary loss of earnings are tax free in England or Canada, even though in practice taxes on them had apparently not been exacted by the Crown . . . A strong case may be made for the contention that in Canada damages in lieu of earnings are taxable even though by administrative tolerance the tax is never levied in practice."<sup>38</sup>

It is understood that in South Australia the Deputy Commissioner has already pursued the matter by making an assessment.

There is as yet no definitive Australian decision on the assessability of the loss of earnings up to the date of trial. Unreported Tasmanian decisions in 1961 and 1965 held that recoveries for the earnings up to the trial are assessable.<sup>39</sup> The Supreme Court of Queensland in *Groves v. United*

35. *Id.*, 47-48.

36. *British Transport Commission v. Gourley* [1956] A.C. 185; *Groves v. United Pacific Transport Pty. Ltd.* [1965] Qd. R. 62; *Black v. Mount* [1965] S.A.S.R. 167; *Beneke v. Franklin* [1975] 1 N.S.W.L.R. 571 (C.A.), and see generally Marks, *op. cit.* (*supra*, n.1), 8-9.

37. *Cf.* Harnett, "Torts and Taxes", (1952) 27 *N.Y.U.L.R.* 614, 627: "the taxation of recoveries carved from pain and feeling is offensive and the victim is more to be pitied rather than taxed".

38. *Posons v. Toronto Stock Exchange* (1965) 46 D.L.R. (2d) 210, 343; [1964] 2 O.R. 547, 680.

39. *Brodie v. Caswell* [1961] Tas. S.R. (N.C.) 6; *Whitaker v. Gobbey* [1965] Tas. S.R. (N.C.) 15.

*Pacific Transport Pty. Ltd.*<sup>40</sup> ruled the other way in 1965 on the ground that a plaintiff has only one cause of action for past, present and future loss of earnings. In that case Gibbs J. was very much guided by the joint judgment of Dixon C.J. and Kitto and Taylor JJ. in *Graham v. Baker*,<sup>41</sup> where it was pointed out that it was incorrect to consider that:

“the right of a plaintiff whose earning capacity has been diminished by the defendant’s negligence is concerned with two separate matters i.e., loss of wages up to the time of trial and an estimated future loss because of his diminished earning capacity . . . A plaintiff’s right of action is complete at the time when his injuries are sustained and if it were possible in the ordinary course of things to obtain an assessment of his damages immediately it would be necessary to make an assessment of the probable economic loss which would result from his injuries.”<sup>42</sup>

*Groves* was later followed by Crisp J. of the Tasmanian Supreme Court who rejected the earlier decisions of that Court.<sup>43</sup> In this respect the present Canadian position should be noted for comparison. In a landmark case which rejected for Canada the *Gourley* rule, one member of the Supreme Court had suggested that there might be ground for assessing losses of wages up to the date of trial:

“For what it is worth, my opinion is that an award of damages for impairment of earning capacity would not be taxable under the Canadian *Income Tax Act*. To the extent that an award includes an identifiable sum for loss of earnings up to the date of judgment the result might well be different. But I know of no decisions where these issues have been dealt with and until this has been done in proceedings in which the Minister of National Revenue is a party, any expression of opinion must be insecure.”<sup>44</sup>

In fact the Revenue were most receptive of this suggestion and the Canadian Tax Appeal Board has confirmed the first assessment.<sup>45</sup> It may well be that the Australian Commissioner will react in the same way, though it is submitted that, should such an assessment be upheld, the hardship relief provision should be liberally applied to prevent high marginal rates applying because of the consequent bunching.<sup>46</sup>

### 3. Wrongful Dismissal

There has been little development in the last three years, through Australian court and board decisions, in the tax treatment of recoveries for breach of employment contracts. In contrast the Federal Court of Canada has recently twice reviewed this problem: in view of the fact that both the Australian and Canadian tax legislation utilises an identical notion of “ordinary income” these decisions must be of relevance to the Australian position. It has been submitted<sup>47</sup> that a recovery for wrongful dismissal should under general principles not be treated as assessable

40. [1965] Qd. R. 62.

41. (1961) 106 C.L.R. 340.

42. *Id.*, 346-347.

43. *Polites v. Hydro Electric Commission* [1970] Tas. S.R. 67.

44. *R. v. Jennings* (1966) 57 D.L.R. (2d) 644, 655 per Judson J.

45. *Cirella v. M.N.R.* (1976) 76 D.T.C. 1211 (Tax. Rev. Bd.).

46. S.265. Cf. 75 A.T.C. Case G8/19 G.T.B.R. (N.S.) Case 102 (No. 1 Bd., 1974).

47. See Marks, *op. cit.* (*supra*, n.1), 14-16.

income. There is no income source to which the payment can be linked since by the very dismissal the existing source (the employment) has vanished. Furthermore, the bonus and benefit provision (s.26(3)) is inapplicable in wrongful dismissal cases. S.26(e) includes within a taxpayer's assessable income "all allowances, gratuities, compensations, benefits . . . allowed, given or granted to him in respect of, or for or in relation directly or indirectly to, an employment of or services rendered by him. . . ." It can hardly be argued that a payment made to a person because he has been prevented from being employed was "in respect of, or for or in relation directly or indirectly to, any employment of or services rendered by him."<sup>48</sup>

There are, however, a number of exceptions to the *prima facie* rule against the non-assessability of wrongful dismissal recoveries. First, to the extent that a recovery compensates for unpaid accrued wages or salary the former employer will derive income under ss.25(1) and 26(e) when it is received. Secondly, where the recovery is paid in a recurrent form, or if it is by payments in mode and amount equivalent to what the former employer would have received under the breached contract, it should be treated as income.<sup>49</sup> Thirdly, in cases where the recovery is in the form of a court award, that part which is compensation for the period up to the date of trial might be assessable under s.26(j) as an indemnity; this, at least, would appear to be the effect of a 1975 unreported decision of the Supreme Court of Victoria, *Jacobsen v. B.L.B. Corp. of Australia* (Gowans J.).<sup>50</sup>

The Federal Court of Canada has now developed a fourth, though limited, exception which is grounded in a principle that an employer is obliged to give an employee reasonable notice of the termination of his employment and, upon failing to do so, must pay him in lieu thereof the salary which would have been earned during the period of notice. Consequently, where an employer fails to give reasonable notice, any recovery by an employee from the employer which is in satisfaction of this implied obligation arising out of the contract of employment will be treated as paid under the contract and hence, for tax purposes, as ordinary income. This exception was developed in 1974 in *Quance v. The Queen*.<sup>51</sup> In that case the taxpayer had been hired as a president of a company; the contract was verbal, and there was no agreement as to the duration of the term. Some ten years later his employment was terminated and in lieu of reasonable notice he was offered nine and a half months salary. On the advice of his solicitor he rejected the offer and claimed that one year's salary should have been paid. The company ignored the rejection and simply paid him the salary by way of cheques for the nine and a half months' term which the former president accepted as part payment. The payments were assessed as income, and Cattanaich J. of the Federal Court

48. *Scott v. Commissioner of Taxation (N.S.W.)* (1935) 35 S.R. (N.S.W.) 215, 221 per Jordan C.J. The contrary result in the United Kingdom appears to have been assumed (but note the different wording in the schedule under the Finance Act, 1976 (U.K.)): *Parsons v. B.N.M. Laboratories Ltd.* [1964] 1 Q.B. 95 (C.A.).

49. *Commissioner of Taxation (Vic.) v. Phillips* (1936) 55 C.L.R. 144; 3 A.T.D. 330.

50. In another 1975 unreported Victorian Supreme Court decision, *Briers v. Atlas Tiles Ltd.* (McInerney J.), it was argued that s.26(j) applied to a damages award for future loss of earnings as a result of wrongful dismissal: the limitations on that section raised, for example, in *Lonie v. Perugini* (1977) 77 A.T.C. 4318 were not considered. *Briers* is presently on appeal to the Full High Court.

51. (1974) 74 D.T.C. 6210.

upheld the assessment. He held that in the absence of an express termination term in an employment contract reasonable notice is required: where the employer fails to give the notice there is a breach of contract and the dismissal is actionable. The measure of damages for the breach would be the salary which would have been earned during the period of notice. It followed that the payment of salary for a period coincident with the period of reasonable notice would prevent the wrongful dismissal from being wrongful and hence it should be treated as income under ordinary principles. *Quance's* case would probably lead to the view that virtually all recoveries for wrongful dismissal would be assessable. Perhaps the only limitation would be where the dismissed employee has also been forced to part with certain rights, such as a right to corporate control; the compensation in respect of that additional capital loss would not be assessable.<sup>52</sup>

In the next year, in *The Queen v. Atkins*,<sup>53</sup> Collier J. of the Trial Division of the Federal Court, and then the Federal Court of Appeal, in effect attacked the underpinnings of *Quance's* case while agreeing with the actual result in that case. There the taxpayer, who was in his early fifties, was dismissed without reasonable notice from a senior position with his employer after eighteen years' service. After threatened litigation he received a significant sum from the employer (it was equivalent to 42 weeks of salary). The termination agreement described the sum as a "severance allowance" and it was accepted "in satisfaction of all . . . claims against the Company for the termination of . . . employment". The Revenue attempted to assess the entire sum on the ground, *inter alia*, that it was salary in lieu of notice. Collier J. disagreed. He accepted that the starting point was that the employer had not given reasonable notice, that this failure was a breach of contract, and that the taxpayer's remedy was compensation for the breach. However, he could not accept that the measure of damages was necessarily restricted to the wages or salary for the period of a reasonable notice. One other element which was required to be considered was the time which the employee would require to find new employment:

"It may well be that in the 1970's some compensatory allowance for that aspect might well be made. I have in mind the dismissal of executives at ages where prospective new employers refuse to engage them, not because of lack of ability, but because of their age and the disturbances which might be caused to existing seniority stratas, and because of the difficulties of injecting new middle-aged (or older) persons into pension schemes."<sup>54</sup>

In the result he held that no part of the recovery was assessable as ordinary income: there was no evidence that the entire amount was intended by the employer to represent only salary or that factors "deserving of compensation and damage" were not included.<sup>55</sup> The *Quance* exception, then, could only apply where the entire recovery received by the dismissed employee could be characterized as salary and nothing else.

Collier J.'s decision was approved by the Federal Court of Appeal<sup>56</sup> which, in a brief opinion, further limited *Quance*. The Court stated:

52. *Cf. Bennett v. Federal Commissioner of Taxation* (1947) 75 C.L.R. 480; 8 A.T.D. 265.

53. (1975) 75 D.T.C. 5263.

54. *Id.*, 5269.

55. *Id.*, 5270.

56. *R. v. Atkins* (1976) 76 D.T.C. 6258.

"Moneys so paid (i.e., 'in lieu of notice of dismissal') are paid in respect of the 'breach' of the contract of employment and are not paid as a benefit under the contract or in respect of the relationship that existed under the contract before that relationship was wrongfully terminated. The situation is not altered by the fact that such a payment is frequently referred to as so many months' 'salary' in lieu of notice. Damages for breach of contract do not become 'salary' because they are measured by reference to the salary that would have been payable if the relationship had not been terminated or because they are colloquially called 'salary'. The situation might well be different if an employee was dismissed by a proper notice and paid 'salary' for the period of the notice even if the dismissed employee was not required to perform the normal duties of his position during that period."<sup>57</sup>

The tax-planning strategies where out-of-court settlements can be arranged are obvious; a recovery paid for a release or withdrawal of the employee's claims which are in respect of loss of income and other intangible matters, such as the difficulty of obtaining alternative employment and the stigma of being dismissed, drawn in such a way that it is impossible to apportion any amount for loss of salary, will most likely be treated as a capital receipt.<sup>58</sup> On the other hand, a recovery which is exclusively for a settlement of a claim for loss of salary under the express or implied terms of the employment contract, and which by its terms cannot be extended to cover other intangible matters, may well fall within the *Quance* rule and thus be assessable.

**(A) S.26(d) AND WRONGFUL DISMISSAL**

In cases of out-of-court settlements for wrongful dismissal the plaintiff will usually have the option in the negotiations to choose either a lump sum award, a series of periodic payments, or two or three payments of different amounts none of which could be regarded as a lump sum. The danger of periodic payments, of course, is that the form of consideration may, in a doubtful case, persuade a court or board to hold the recovery to be in the nature of income. A court award or a lump sum settlement on the other hand, may suffer *some* tax, even if at a reduced rate. S.26(d) brings into assessable income five per cent. of compensation "where that amount is paid in a lump sum in consequence of retirement from, or termination of, any office or employment, and whether so paid voluntarily by agreement or by compulsion of law". It is undoubted that this provision has the effect of making taxable, but only to the extent of five per cent, payments which are otherwise non-assessable because of their capital nature. It has generally been assumed that lump sum wrongful dismissal awards fall within the section, and this view now has the support of McInerney J. of the Supreme Court of Victoria in an unreported 1975 judgment, *Briers v. Atlas Tiles Ltd.* Where, however, there is more than one payment—in practice it is usually two or three payments of different amounts—s.26(d) appears to be inapplicable. It can hardly be said that an "amount is paid in a lump sum" if there is more than one payment.

It was previously suggested<sup>59</sup> that the causation requirement in s.26(d) limited its application and that in the case of settlements involving lump

57. *Id.*, 6258-9.

58. For a case which followed and accepted *Atkins*, see *Burgess v. M.N.R.* (1976) 76 D.T.C. 1119 (Tax. Rev. Bd.).

59. Marks, *op. cit.* (*supra*, n.1), 17-18.

sum payments there was a definite strategy whereby even the 5% of the lump sum could be excluded from tax. In the case of an amicable arrangement or a negotiated settlement the cause of the payment will be the retirement or termination. To reduce the assessable amount from 5% to nil, however, all that the employee might have to do is to establish that the compensation was paid for a different reason: by instituting legal proceedings against his employer for the breach or anticipated breach, it was submitted, a change in causation could be effected. If there is a court judgment or arbitral award the payment of compensation is in consequence of the judgment or award; if there is a settlement after the commencement of legal proceedings, the compensation is paid by the employer not for the termination of employment but to avoid legal proceedings, that is, to obtain a release from the employee's cause of action for wrongful dismissal. In view of the 1975 High Court decision in *Reseck v. Federal Commissioner of Taxation*<sup>60</sup> this suggestion should now be treated with some caution. In that case Jacobs J. considered a submission "that the words 'in consequence of' import a concept that the termination of the employment was the dominant cause of the payment". He commented: "This cannot be so. A consequence in this context is not the same as a result. It does not import causation but rather a 'following on'."<sup>61</sup> Gibbs J., however, ventured a different view:

"Within the ordinary meaning of the words a sum is paid in consequence of the termination of employment when the payment follows as an effect or result of termination . . . It is not in my opinion necessary that the termination of the services should be the dominant cause of the payment."<sup>62</sup>

While the difference between these two views is not very clear<sup>63</sup> both would probably lead to the conclusion that a lump sum payment paid as a consequence of a withdrawal or release by an employee of a claim against his employer as a result of his wrongful dismissal would come within s.26(d). Dismissed employees with co-operative former employers, however, should have little difficulty in obtaining, in the short term, lump sum payments which are completely tax free. The generally accepted method is to take the recovery initially in a periodic form, for example, in weekly payments, and then, *after* one or two payments are received (probably as assessable income), to convert the remainder of the payments into a lump sum (after determining the actuarial present real value of the future payments). This lump sum would be treated as capital;<sup>64</sup> it would, further, not be received "in consequence of retirement" but, rather, in consequence of giving up a right to future income.<sup>65</sup>

*Briers v. Atlas Tiles Ltd.*, though unreported, is an important case in another respect. It directly raised the issue whether a lump sum court award for wrongful dismissal, assumed to be taxable under s.26(d), is to be subject to a *Gourley* set-off. At least three choices were open to the

60. (1975) 75 A.T.C. 4213; 5 A.T.R. 538.

61. (1975) 75 A.T.C. 4213, 4219; 5 A.T.R. 538, 545.

62. (1975) 75 A.T.C. 4213, 4216-4217; 5 A.T.R. 538, 541.

63. See generally 77 A.T.C. Case J33/21 C.T.B.R. (N.S.) Case 55 (No. 2 Bd., 1977).

64. Cf. *Tilley v. Walls* [1943] A.C. 368 (H.L.).

65. Cf. *Full Report of the Taxation Review Committee* (Asprey Committee) (1975), para. 21.50; 76 A.T.C. Case HA1/21 C.T.B.R. (N.S.) Case 9 (No. 3 Bd., 1976) (Commissioner's appeal to Supreme Court of Queensland allowed by consent).

court. First, it could be argued that since only 5% was taxable under the section the remaining 95% recoverable as damages must not be assessable and hence should be the subject of a *Gourley* set-off. Secondly, the *Gourley* rule could be strictly applied: it only applies when no part of the damages will be assessable to tax; since there will be some tax imposed, even if only on 5% of the award, it should follow that the entire award would not be subject to any tax set-off. Thirdly, *Gourley* could be taken to its logical conclusion by the court going through two sets of calculations: the court would firstly calculate the net amount of damages (as reduced by *Gourley*) to which it would add the plaintiff's tax liability under s.26(d). McInerney J. opted for the second alternative. His Honour stated that Parliament in s.26(d) had fixed a rate of taxation on the entire lump sum and that he was "bound to respect and to give effect to that rate". He then went on:

"In my view, the damages which I will hereafter award, are subject to taxation under s.26(d) to the extent of five per centum only and no more. My view further is that to apply the *Gourley* principle in such a way as to make deductions for tax in assessing the (95%) of the lump sum paid as damages—a process which can be carried only in respect of the full amount (the 100%) of the lump sum in question—would be to set at nought the legislative policy which I consider is discernible from the combined effect of para.(d) and (e) of s.26 . . . For the foregoing reasons, I consider that in the assessment of the damages in this case I should make no deduction for taxation. I should, I consider, calculate the damages on a footing of the gross amounts which would have been payable by the plaintiff had his employment not been wrongfully terminated, leaving the fiscal consequence of my award to be worked out hereafter between the plaintiff and the Federal Commissioner of Taxation."

#### 4. Breach of Contract

Probably the most common tax/litigation question concerns the tax characterization of recoveries for breach of or releases from contracts which have been entered into in the course of business. It is easy to ask "what is the character of the receipt in the hands of the taxpayer?"<sup>66</sup> and reply that "moneys recovered from any source representing items of a revenue account must be regarded as received by way of revenue".<sup>67</sup> A functional reply, however, is considerably more difficult to formulate. The Act provides no guidelines and the adviser is then forced to synthesise the numerous court and board decisions defining the concept of "ordinary income". Fortunately, it can now be assumed that there is a general principle with which virtually all cases can be reconciled: where a contract is a part of the "business operations" of the taxpayer any recovery for its breach or anticipated breach will be of an income nature. But if the contract is concerned with the "fundamental construction or organisation of the business" or it is the "entire business undertaking" then a recovery for the breach will be a capital receipt. The principle has significant

66. *Per Bowen C.J. in Federal Coke Company Pty. Ltd. v. Federal Commissioner of Taxation* (1977) 77 A.T.C. 4255, 4264; 7 A.T.R. 519, 529 (Full Fed. Ct.).

67. *Federal Commissioner of Taxation v. Wade* (1951) 84 C.L.R. 195, 112; 9 A.T.D. 337, 341 *per Dixon, Fullagar JJ.*

support in Australia,<sup>68</sup> the United Kingdom<sup>69</sup> and Canada.<sup>70</sup> It is not proposed here to analyse the numerous decisions which have applied this principle but, rather, to put forward a number of propositions which are supported by the author's earlier study.<sup>71</sup>

(1) It can be expected that a recovery by a supplier for breach of a contract to sell goods will *prima facie* be income. Probably it is only in the case of an unusual long-term supply contract that a seller could reasonably assert that the breached contract was part of the framework or capital structure of his business and thus the recovery should be characterized as a capital receipt. It is now clear that a guaranteed long-term customer is not a capital asset, and the fact that the supplier has incurred capital expenditure to carry out the contract appears to be irrelevant.<sup>72</sup> It is submitted that only in cases where, under the terms of the settlement, the supplier is not permitted to supply the same or similar goods to other customers will the recovery be treated as capital. But the High Court has not been influenced by a finding that the supplier was unlikely to find other customers due to the depressed state of the market.<sup>73</sup>

(2) A purchaser of goods who recovers damages from a supplier for failure to deliver or for late delivery will invariably be assessed on the compensation since it will represent his loss of profit. However, if it can be established that a failure to deliver resulted in a termination of a purchaser's business or damage to goodwill, then, on principle, the recovery would be a capital receipt.<sup>74</sup> In addition, a recovery for late delivery might be treated as a reduction of the purchase price (and not compensation for loss of profits) provided there is supporting evidence to this effect.<sup>75</sup>

(3) Recoveries for breach of marketing, distributorship, agency and management service contracts, though governed by the same principles, appear to be treated somewhat more generously by the boards and courts than those recoveries in (1) and (2). A recovery may be characterized as capital even if the breach does not result in the complete termination of the taxpayer's business,<sup>76</sup> but there must be a significant rupture<sup>77</sup> and

68. *Californian Oil Products Ltd. v. Federal Commissioner of Taxation* (1934) 52 C.L.R. 28; *Heavy Minerals Pty. Ltd. v. Federal Commissioner of Taxation* (1966) 115 C.L.R. 512; 14 A.T.D. 282; and *cf. Federal Coke Company Pty. Ltd. v. Federal Commissioner of Taxation* (1977) 77 A.T.C. 4255.

69. *Burmah Steam Ship Co. Ltd. v. I.R.C.* [1931] S.C. 156; 16 T.C. 67; *Van den Berghs Ltd. v. Clark* [1935] A.C. 431; 19 T.C. 390; *Kelsall Parsons & Co. v. I.R.C.* [1938] S.C. 238; 21 T.C. 608; *Barr Crombie & Co. v. I.R.C.* [1945] S.C. 271; 26 T.C. 406; *I.R.C. v. Fleming & Co. (Machinery) Ltd.* [1952] S.C. 120; 33 T.C. 57; *Wiseburgh v. Domville* [1956] 1 All E.R. 754; 36 T.C. 527.

70. *Frankel Corp. v. M.N.R.* [1959] S.C.R. 713; 59 D.T.C. 1161; *Parsons-Steiner Ltd. v. M.N.R.* [1962] Ex. C.R. 174; 62 D.T.C. 1148; *H. A. Roberts Ltd. v. M.N.R.* [1969] S.C.R. 719; 69 D.T.C. 5249; *M.N.R. v. Import Motors Ltd.* (1973) 73 D.T.C. 5530.

71. See generally Marks, *op. cit.* (*supra*, n.1), 19-34.

72. *Heavy Minerals Pty. Ltd. v. Federal Commissioner of Taxation* (1966) 115 C.L.R. 512; 14 A.T.D. 282; *Great Lakes Paper Co. Ltd. v. M.N.R.* (1961) 61 D.T.C. 564 (Tax. App. Bd.).

73. See *Heavy Minerals Pty. Ltd. v. Federal Commissioner of Taxation* (1966) 115 C.L.R. 512, 516 *per* Windeyer J.

74. *Cf. Californian Oil Products Ltd. v. Federal Commissioner of Taxation* (1934) 52 C.L.R. 28.

75. *Crabb v. Blue Star Line Ltd.* [1961] 2 All E.R. 424; 39 T.C. 482.

76. A recovery for a contract breach which results in the relinquishment and abandonment of the taxpayer's business will be capital; *Californian Oil Products Ltd. v. Federal Commissioner of Taxation* (1934) 52 C.L.R. 28.

77. *Barr, Crombie & Co. v. I.R.C.* (1945) S.C. 271; 26 T.C. 406.



hence each type of business should be examined separately. The decisions suggest that the following criteria are important in determining the proper tax characterization of recoveries for breaches or cancellations of these contracts. First, if a taxpayer has made special arrangements to carry out the cancelled contract, for example, built special plant, acquired special knowledge, or otherwise geared his business to the contract, then compensation for the cancellation would be a capital receipt.<sup>78</sup> The second factor is the converse of the first: if, as a result of the cancellation a taxpayer is forced to lay-off employees, sell property or close some of his offices or branches, the compensation will also be a capital receipt.<sup>79</sup> Thirdly, if the taxpayer is seriously restricted in his activities in the same line of business as a result of the cancellation of the contract the compensation will be a capital receipt, for example, where a taxpayer is bound by a duty of confidentiality to his former client or enters into a restrictive covenant not to conduct a similar business in the future. Lastly, if the contract is cancelled towards the end of its term then compensation is likely to be an income receipt.<sup>80</sup> On the other hand, if the unexpired term is a "substantial" period then compensation is likely to be treated as a capital receipt.<sup>81</sup> The last case is even stronger where the contract is cancelled before actual operations begin.<sup>82</sup>

(4) A deposit forfeited by a purchaser and retained by a vendor as a result of the purchaser's non-performance of a contract will be treated as a recovery with (1).<sup>83</sup> The forfeited deposit may also be assessable under the second limb of s.26(a).

### 5. Tortious Injury to Working Capital

The recent decision of the South Australian Full Court in *Lonie v. Perugini*<sup>84</sup> has raised afresh the problem of the tax treatment of recoveries for torts to working capital. There the plaintiff and the defendant were the owners of adjoining properties in the Adelaide hills area. The defendant lit a fire on his property which spread to that of the plaintiff and destroyed the majority of his fruit trees. The plaintiff sued in negligence and under the *Rylands v. Fletcher* rule recovered damages (being the loss of profits from fruit sales for ten years).<sup>85</sup> Judgment was delivered five years after the date of the fire. It appeared at trial that counsel for both parties did not raise the issue of the taxability of the award and the trial judge made no finding in this respect. The defendant appealed on two grounds, the

78. *Sabine v. Lookers Ltd.* [1958] T.R. 213; 38 T.C. 120; *M.N.R. v. Import Motors Ltd.* (1973) 73 D.T.C. 5530; 15 C.T.B.R. Case 17 (No. 1 Bd., 1946); 76 A.T.C. Case H7/20 C.T.B.R. (N.S.) Case 61 (No. 2 Bd., 1976); cf. 75 A.T.C. Case G57/20 C.T.B.R. (N.S.) Case 29 (No. 1 Bd., 1975).

79. *Californian Oil Products Ltd. v. Federal Commissioner of Taxation* (1934) 52 C.L.R. 28; *Barr, Crombie & Co. v. I.R.C.* (1945) S.C. 271; 6 T.B.R.D. Case F5/5 C.T.B.R. (N.S.) Case 23 (No. 2 Bd., 1954).

80. *Kelsall Parsons & Co. v. I.R.C.* [1938] S.C. 238; 21 T.C. 608; but cf. *Shove v. Dura Manufacturing Co.* (1941) 23 T.C. 779.

81. *Barr, Crombie & Co. v. I.R.C.* (1945) S.C. 271.

82. 15 C.T.B.R. (N.S.) Case 17 (No. 1 Bd., 1946).

83. There appears to be no Australian case in point. For decisions in New Zealand and Canada see 5 N.Z.T.B.R. Case 13 (N.Z. Bd., 1971); *Melcrete Construction Co. Ltd. v. R.* (1977) 77 D.T.C. 5181.

84. (1977) 77 A.T.C. 4318; 7 A.T.R. 674.

85. The ten year period was calculated as follows: (a) that it was reasonable for the plaintiff to wait two years to see if the trees would regenerate, and (b) since the trees then had to be replaced, a further eight years by which time the trees would be "fully producing".

most significant of which concerned the taxability of the award and whether the trial judge should have allowed a set-off under the *Gourley* rule.

The Court was unanimous in finding that the award for loss of profits up to the date of trial (five years) was assessable but it divided on the tax treatment of that part which related to future losses (a capitalized lump sum). It will be recalled that Bray C.J. held that s.26(j) could be read to cover losses of future profits;<sup>86</sup> His Honour was thus prepared to hold that the recovery for future damage was assessable under that provision. The other two judges, Hogarth and King JJ., disagreed: the damages were not assessable under s.26(j) because of the awkward wording of the provision (and on that ground a *Gourley* set-off should have been allowed).<sup>87</sup> But on the question whether the recovery for future lost income was assessable as ordinary income under s.25(1) the judgments are most unsatisfactory. Bray C.J. indicated that the recovery would have been income.<sup>88</sup> King J. disagreed,<sup>89</sup> while Hogarth J. remained silent but must have assumed that this part of the award was not ordinary income. Consequently, King and Hogarth JJ. applied a *Gourley* set-off to the award.

The decision that the recovery for loss of income up to the date of trial is to be characterized as ordinary income is in agreement with two earlier Australian decisions,<sup>90</sup> and authorities in England<sup>91</sup> and Northern Ireland,<sup>92</sup> and hence a principle to this effect can now probably be safely put forward.<sup>93</sup> As to the recovery for lost future income King J. simply said:

“The question as to that part of the award which represents compensation for loss of income in the future stands differently. Compensation for loss of future income cannot be regarded as income according to ordinary concepts.”<sup>94</sup>

No authority in support of this statement was given. In reply Bray C.J. was equally adamant:

“A sum received now in commutation of a right to accrue in the future or over a future period or as compensation for the loss of renunciation of such a right is normally treated for taxation purposes as income in the year of receipt.”<sup>95</sup>

The Chief Justice supported his statement by relying exclusively on breach of contract cases,<sup>96</sup> which, it is submitted, are quite irrelevant to the issue under discussion. In characterizing a recovery for damage to a capital asset, the only contract cases relevant would be those where the contract was a capital asset, that is, where the contract was a part of the fundamental

86. (1977) 77 A.T.C. 4318, 4330; 7 A.T.R. 674, 687.

87. See *supra*, nn.15-16b.

88. (1977) 77 A.T.C. 4318, 4323; 7 A.T.R. 674, 679.

89. (1977) 77 A.T.C. 4318, 4330; 7 A.T.R. 674, 687.

90. *Robert v. Collier's Bulk Liquid Transport Pty. Ltd.* [1959] V.R. 280; *Williamson v. Commissioner for Railways (N.S.W.)* (1959) 60 S.R. (N.S.W.) 252.

91. *London and Thames Haven Oil Wharves Ltd. v. Attwooll* [1967] Ch. 772; 43 T.C. 491 (C.A.); *Pryce v. Elwood* (1964) 108 Sol. J. 583.

92. *Morahan v. Archer & Belfast Corp.* [1957] N.I.R. 61.

93. See Marks, *op. cit.* (*supra*, n.1), 35-36.

94. 77 A.T.C. 4318, 330; 7 A.T.R. 674, 687.

95. 77 A.T.C. 4318, 4323; 7 A.T.R. 674, 679.

96. *Short Bros. v. I.R.C.* (1927) 12 T.C. 955; *I.R.C. v. Northfleet Coal & Ballast Co.* (1927) 12 T.C. 1102.

structure of the taxpayer's profit-making apparatus; and the High Court, the House of Lords, and the Supreme Court of Canada have all held that such recoveries are capital receipts.<sup>97</sup>

It is suggested, on principle, and in line with the *Californian Oil Products* case,<sup>98</sup> that King J.'s statement is correct, provided it is qualified to apply to compensation as a result of the total loss or destruction of a capital asset. In this respect it is useful to consider a *dictum* of Willmer L.J. in *London and Thames Haven Oil Wharves Ltd. v. Attwooll*,<sup>99</sup> where it was clearly indicated that a tort recovery for this type of loss would be wholly treated as a capital receipt:

“ . . . there is all the difference in the world between a total loss and a partial injury. In the case of a total loss, what can be recovered from the assumed wrongdoer is the value of that which has been lost. If the thing lost is a ship or jetty which is ordinarily used for the purpose of earning profits, the fact of its profitability is an element to be considered in assessing its capital value. In such a case the owner's right is a right to recover the value of the thing which has been lost, and this can no doubt be properly described as ‘whole and indivisible’, even though it includes some element of profitability of the thing lost; in such circumstances what is recovered is properly treated as a capital receipt.”<sup>100</sup>

It is suggested, following *Californian Oil Products*, that an even stronger case for categorizing a recovery for a loss of an item of working capital as a capital receipt would be where the damage caused, even for a short time, the actual closure of the plaintiff's business.

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97. See cases cited *supra*, nn.68, 69, 70.

98. *Californian Oil Products Ltd. v. Federal Commissioner of Taxation* (1934) 52 C.L.R. 28.

99. [1967] Ch. 772.

100. *Id.*, 806.