CAPITAL GAINS TAX AND ARBITRATION AWARDS

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Increasingly arbitrators will be faced with a claim that the amount of damages awarded should recognise capital gains tax (CGT) that may be payable on the award. Unfortunately the law is not clear but the position of the Australian Taxation Office ("ATO") is coming into focus.

Two issues arise, the first being whether or not the compensation received by the injured party is subject to CGT. The second question, of no less concern, is whether or not the injured party is to be compensated for that CGT exposure (if any) in the award of damages.

IS AN AWARD SUBJECT TO CGT?

The most significant development on the CGT treatment of damages has been the release of a draft taxation ruling by the ATO in August (TR94/D35). Whilst this document of 53 pages is only a draft and even when final does nothing more than set out the views of the ATO (and is therefore no guide as to how a Court may ultimately determine these questions), it does provide a framework for analysis.

Perhaps not unexpectedly, the ATO finds a taxation consequence in all situations other than those involving assets held prior to 19 September 1985 or some other specific exemption.

The framework set out in the draft ruling is as follows:

- Actual disposal of the underlying asset, including a disposal through loss or destruction of part or all of the asset.
- Compensation for permanent damage or permanent reduction in the value of an underlying asset where -
  - the compensation does not exceed the total acquisition costs of the asset, and
  - where the total acquisition costs are exceeded by the amount of compensation.
- Cases where the action does not involve the "disposal" of an underlying asset but rather the disposal of the "right to seek compensation ".
- Other cases involving the disposal of rights to compensation which would attract CGT.

From the perspective of litigants before arbitration, it seems that any one of these situations might be encountered.

The following notes merely touch the most obvious aspects of the draft ruling and, for those who may be affected, are no substitute for a close reading of the document.

ACTUAL DISPOSAL OF THE UNDERLYING ASSET

In general, there is little debate that where the damages are awarded to compensate for the total loss or destruction of an entire asset, or a distinct part of it, there is a disposal of the asset and the compensation received should be treated as consideration for that disposal with ordinary CGT consequences. That means that the recipient is taxable upon the difference between the compensation received and the cost of the asset lost or destroyed, after allowing for movements in the consumer price index during the period of ownership. However, if the asset concerned was acquired by the recipient of the damages prior to 19 September 1985, there will be no CGT impact. Similarly, in some circumstances there will be roll-over relief which will attribute to the replacement asset some of the attributes of the original asset, now lost.

In these cases, the damages are merely treated as if they were the proceeds of a sale of the underlying asset.

COMPENSATION FOR PERMANENT DAMAGE

It will be much more common for damages to be awarded by way of recompense for a loss resulting from damage to property which falls short of its total loss or destruction. The draft ruling contemplates the amount of compensation received going to reduce the cost base of the asset in question and, to the extent that the consumer price indexed cost base is exceeded, for the proceeds to be taxable as a capital gain.

This thrust is contrary to the views expressed by Harper J. in the Supreme Court of Victoria in *Carborundum Realty Pty Ltd -v- RAIC Archicentre Pty Ltd & anor. 93 ATC 4418* and Davies J. of the Federal Court of Australia in *Namol Pty Ltd -v- AW Baulderstone Pty Ltd 93 ATC 5101.*

In these cases, their Honours separately stated that in their opinion the CGT provisions should have no role to play "in the ordinary circumstance of compensation for loss brought about by the actual default on another person".

These cases were not concerned directly with the question as to whether or not CGT was payable on the damages awarded? Rather these cases were directed towards the second question, that is, whether the CGT payable, if any, should be recognised in the quantum of the damages awarded. It may be some time before the Courts have to consider the question in an action in which the Australian Taxation Office is a party.

It appears then, for a time at least, the unhappy litigant will be in the position of *Carborundum Realty Pty Ltd* which found itself holding a ruling from the Commissioner that the compensation would be taxable but obtaining no recognition of that liability in the quantum of the damages awarded.

In the context of damages that go towards a diminution in the value of an asset, the Commissioner's ruling not only flies- in the face of the judicial pronouncements referred to above but also seems to be insecurely

based. It is premised on the notion that in determining the cost base of an asset for CGT purposes, account should not be taken of an amount or value "in respect of which the taxpayer has been recouped or is entitled to be recouped by any person". The ruling quotes a wide definition of the word "recoup" from the Macquarie dictionary. It is yet to be demonstrated that this definition is wide enough in the context of the relevant section to permit an award of damages to be seen as a part of the recoupment of the original expenditure of a taxpayer on the asset concerned. The Commissioner's argument seems to be weaker still when he argues that the excess of an award of damages over the cost of the asset, whilst not representing a taxable capital gain derived from the disposal of that asset, represents consideration received on the disposal of "another asset" being the right to seek compensation or some notional asset, and that as such, may result in an immediate CGT liability.

COMPENSATION PAYMENTS NOT INVOLVING AN UNDERLYING ASSET OTHER THAN THE RIGHT OF ACTION ITSELF

The draft taxation ruling argues that the right to recover compensation is, itself, a separate "asset" as expansively defined for CGT purposes. In this regard the Commissioner is probably correct. But in the draft ruling, an award of damages is said to be consideration received on the disposal of that "asset", the right of action, and so taxable, except where the damages are dissected so as to attribute specific amounts to the loss of separate assets, or where the compensation is for any wrong or injury suffered "by the taxpayer to his or her person or in his or her profession or vocation" and so expressly exempt. This produces the alarming concept that the extinction of that claim through the determination of an Arbitrator, Tribunal or Court, would crystalise a capital gain, with the consideration being the amount of compensation awarded, and the cost base being limited to "incidental costs", the most obvious of which are legal fees.

Draft taxation ruling TR94/D35 paints a surreal picture which, if its assertions are fully adopted by the Courts (which may be doubted), will have perverse and unexpected outcomes for litigants in the case where lump sum damages are paid without dissection.

The draft taxation ruling is silent on the question of the generation of capital losses as a consequence of the outcome of meeting compensation payments by the unsuccessful party but there is no technical reason why capital losses should not be generated upon the "disposal" of the right of action by the unsuccessful party.

RECOGNITION OF CGT IN AWARDS

As has been mentioned above, the question of the incidence of CGT on compensation payments has arisen primarily as a result of litigants seeking recognition of the liability for CGT that may fall upon them as a consequence of the award, thus seeking a "grossing-up" of the amount of

damages. No doubt this question will also continue to arise in claims before Arbitrators.

In its draft ruling, the ATO asserts that where an amount is so grossed-up the additional compensation "also represents consideration received as a result of or in respect of the disposal of the underlying asset. "

In the recent cases mentioned, the Courts have declined to provide such a supplement to a successful litigant. In Namol, Davies J. set out the reasons why he did not make any allowance for CGT with respect to damages falling under three heads.

• Damages relating to loss of profits from the exploitation of copyright

Davies J held that this part of his award served to replace income that was lost and that, as a result, the award probably would have been subject to income tax. As the before-tax amount was awarded, there was no need for any adjustment. This principle would equally follow if the amount of compensation was replacing a receipt that would have otherwise been taxable as ordinary income or otherwise constituted consideration for the disposal of an asset subject to CGT. The example of compensation for the total loss or destruction of an asset subject to CGT is a case in point.

• Punitive damages

In Namol, an amount of $150,000 was awarded for "aggregated default". These damages were awarded to reflect the seriousness of the conduct of the offending party and not to compensate for any loss. Davies J. held that "if the tax laws require the payment of CGT on that sum, then that is simply what the laws of the land provide" and no adjustment of the amount was made.

• Interest included in the award

Davies J. held that even if this amount was subject to CGT (as distinct from income tax), the Court does not aim to ensure that the litigant received this settlement tax free.

Outside of such cases as Namol, there is little guidance from the Courts to date as to whether allowance should be made by arbitrators for CGT. This is partly due to uncertainty as to whether CGT is payable (but a public taxation ruling on the matter may help to at least underline that risk) but also as to how the adjustment should be provided so as to allow for the varying and uncertain taxation circumstances of the recipient.

For the present, Arbitrators should approach the question cautiously and, in particular, seek argument and, if necessary, expert guidance on the incidence of CGT in the hands of the successful party before recognising that impost in the quantum of damages awarded.