Captial gains tax ruling

by John Morgan

Ruling TR95/35 and the threat of grossed-up damages

If you're wondering how a loss could be taxed as a gain, you're on the right track. If you're wondering how we could have a parliament that passes such laws and a tax office that interprets them that way, don't adjust your sets - reality has been at fault - until now, perhaps. Let me explain.

Don't be fooled by some of the glib commentary that complains about compensation receipts being subject to CGT per se. Sometimes they have to be, where the compensation relates to an asset (or what the ruling calls an "underlying asset").

Take, for example, a painting that has risen in value so that you would pay CGT if you sold it. If the painting were destroyed and you received compensation equal to its market value, there is nothing wrong with treating the compensation just like sale proceeds. They are both consideration for the disposal of an asset, and you would expect to pay CGT in either case.

If the same painting were damaged but not destroyed, there could still be CGT consequences even though the compensation receipt was not disposal consideration. Take, for example, a painting for which you had paid $10,000, and you receive $5,000 in compensation for damage that reduces its value to $5,000. You would expect the $5,000 in compensation to reduce your $10,000 CGT "cost base" down to $5,000 to match the real situation. Then if you sold it for $5,000 you would have neither a capital gain or a capital loss.

The problem is with compensation receipts where there is no underlying asset at all, e.g. personal injury or suffering a liability. If compensation receipts can be subject to CGT in these circumstances then capital gains strays into an area where it has no business at all. It is, after all, a tax on the disposal of assets, and if there is no underlying asset that has been damaged or destroyed, then there is no reason for the compensation receipt to be taxed. The problem with letting GCT stray into this area is that it can introduce the prospect of judges grossing up to the award of damages to allow for the tax on the damages receipt. This in fact happened in the case of *Tuite v Exelby*[1] and it was this case that has put the cat among the pigeons. The plaintiff had suffered an $800,000 loss, but the judge decided that to give the plaintiff $800,000 after CGT he would need to award $1,300,000 in damages because it looked like the damages would be taxable in full (under the old s160M (7). The gross-up was necessary to leave the plaintiff in the position he would have been in had the wrong not occurred. The gross-up will only be necessary when the plaintiff is taxed on the compensation but wouldn't have been taxed on the underlying subject matter of the compensation.

The tax effect on damages can be represented in a simple matrix as set out below.

	Damages (TAXABLE)	**Damages (NOT TAXABLE)**
Subject of Compensation (TAXABLE)	No Effect	DISCOUNTED
Subject of Compensation (NOT TAXABLE)	**GROSSED UP**	No Effect

It is the mismatch between the compensation being taxable and the underlying subject matter of the compensation not being otherwise taxable that leads to the problem. In these circumstances the judge must gross-up damages for tax in order to leave claimants in the position they would have been but for the wrong. The *Tuite* case shows that grossing-up damages could be very expensive, especially across a whole nation.

Grossing-up damages for tax is, I believe, unprecedented in our common law history. I understand that we would be the only country in the world where damages could cost twice as much as the damage done. Such an outcome can hardly be in our national interests.

In my opinion there should be a simple and cast iron guarantee that tax could never interfere in a way that causes gross-up of damages, but as much as this new ruling tries, it doesn't give this guarantee. This probably requires legislative change .

How is this Silliness Possible?

The problem lies primarily in regarding the right to seek compensation as an "asset" in its own right, and then in a series of restrictive definitions or interpretations in our CGT provisions. The argument for taxing every compensation receipt goes like this:

- The right to seek compensation is an "asset"(s160A)
- There is a deemed disposal of this asset when the compensation is received, as this satisfies the right to seek compensation which then ceases to exist (s160M(3)(b)).
- The CGT provisions are triggered once there is a "disposal" of an "asset" so that you must calculate whether or not you have a "capital gain" (s160Z). This depends in essence on whether the "consideration in respect of the disposal" of the asset (i.e. the right to seek compensation) exceeds its "cost base".
- The consideration for disposing of the right to seek compensation is the amount of compensation received (s160ZD).
- The cost base is limited to the legal fees or other costs necessary to prosecute the claim, and does not include an amount for the loss that is the subject of the compensation claim (s160ZH(4)).

There are some technical arguments against most of these propositions, but it is hard to land a knockout punch and

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hence there is considerable danger of CGT applying where it shouldn't and damages being grossed-up to allow for this tax. This all flows from the need to treat compensation rights as a CGT asset separate from the underlying subject matter of the compensation.

In fact, it is because the right to sue has been treated as an "asset" that we call the real asset which has suffered the loss (where there is one) the "underlying asset".

There is also a problem with what the ruling calls "notional assets" under a catch-all provision known as s160M (7). While the general scheme of our CGT is to tax gains on disposal of assets, there are catch-all provisions which can also tax gains that don't flow from disposals of assets. There can be tax when a person gets money or other consideration as a result of an act, transaction or event in relation to an asset without actually disposing of it or any other asset under s160M (7). The receipt is made taxable by pretending that it was received in respect of a deemed disposal of a notional asset.

This section probably depends on there being an underlying asset which is affected, but it could also apply whenever the underlying asset was not actually disposed of, e.g. where an asset is only damaged or its value reduced. One positive aspect of treating compensation rights as an "asset" is that it prevents s160M(7) applying, as that section can't apply where there is an asset that has been disposed of.

The English encountered the same problems with their law, and dealt with them far more deftly than we have by an "extra statutory concession" to not apply the law strictly, which our Commisioner of Taxation doesn't have with rulings. In any event, the way they solved it can be neatly conveyed by quoting the summary at the beginning of the concession itself:

"The receipt of damages or compensation payments can give rise to a capital gains tax liability. Broadly the concession will now treat damages:

- *as derived from any underlying assets (and therefore exempt from tax if the asset is exempt, and taxable, if the asset is taxable), unless*
- *there is on underlying asset, when damages will be exempt."*

The previous draft of the ATO ruling (TR94/D35) managed to go halfway to the English position. It succeeded in linking the damages to the underlying asset where there wasn't one. Its main shortcoming was that it couldn't go the rest of the distance and deliver a nil tax result where there was no underlying asset.

The final ruling goes a long way to overcoming the problem with the "no underlying asset" situation, but it hasn't eliminated the problems, as I will discuss below.

How the Rules Will Work

The final ruling still treats a right to seek compensation as an "asset" (para 32-65). There is not much argument about this technically, particularly after the definition of asset (in s160A) was widened from 25 June 1992. However this remains the heart of the problem and should be corrected by changing the law.

The ruling also still treats the receipt of compensation as disposing of the compensation right (para 90-93). While ther is not much argument about this technically, it does mean that you must go through the following analysis for every compensation receipt to assess its CGT status.

The first question you ask is whether or not the compensation is in respect of an underlying asset. If it is then the ATO has to choose which is the relevant asset. It is prepared to say that it is more apapropriate to treat the compensation as relating to underlying asset than to the right to compensation (para 69-82).

If there is an underlying asset, then there are several important consequences:

1. If the underlying asset is exempt from CGT (e.g. a principal residence or pre-1985 asset) then the compensation is also exempt, as it relates to the exempt asset (para 66-68).
2. If there is a disposal of a non-exempt underlying asset, then the compensation will be treated as disposal consideration of the underlying asset (para 140-145). Typically in compensation situations, there will be a disposal because the underlying asset has been lost or destroyed. This is deemed disposal (s160N).
3. If there is no disposal of the underlying asset then the approach is different. The compensation will be compensated as recouping the cost base of the underlying asset under s160ZH(11) (para 125-139). This will impact on the capital gain calculation when there is a disposal of the underlying asset and it will involve the loss of indexing on that amount (para 146-152). Generously though, the ATO has conceded that a recoupment amount which exceeds the cost base is not assessable (para 133).

Generally, the underlying asset will not have been disposed of because it has been damaged rather than lost or destroyed. Alternatively, it may be that the asset has not been physically harmed but has had its value diminshed, or the taxpayer may have paid too much for the asset by virtue of the compensable event, e.g. because the painting was not an original.

The first of these two rules are good and produce no gross-up of damages - any tax payable would have been payable anyway. The third recoupment rule has its benefits, but also some annoying loose ends which I will discuss later.

If the compensation doesn't relate to any underlying asset at all, then the ATO feels compelled to look at the compensation rights as the only available asset, and the compensation as relating to a disposal of those rights. On this basis it will assess the recipient of the compensation as a capital gain equal to the compensation amount, less the cost base amount for the compensation rights (para 153-171).

Under the draft ruling the cost base for compensation rights was limited to legal fees and other costs in prosecuting the claim, but there has been an important breakthrough in the final ruling (para 94-105). If the compensation is for any money that the taxpayer has paid or will have to pay, then the ATO will allow these monetary amounts as part of the cost base for the compensation rights (para 103).This is on the basis that they have been or will be paid "in respect of" the compensation rights thus acquired (under s160ZH(4)(a). The ruling requires there to be a "direct and substantial link" between the amounts paid or payable, and the right to compensation, but this will usually exist if the person is being compensated for having to make those payments.

This obviously doesn't let all types of loss into the cost base for the compensation rights, but the ATO is hoping it has this problem covered in other ways.

The compensation could be for property loss, but if it is there will usually be an underlying asset. The ATO then looks at the underlying asset, not the compensation rights, so it won't matter what is or is not included in the cost base of the compensation rights. (Under s160ZH(4)(b) you can only include the

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value of property "given" in your cost base, and property losses may not amount to a person having "given" any property.)

There are other sorts of compensable losses, but in large measure they fall within another important exemption in the Act. Section s160ZB(1) exempts compensation for a wrong or injury to your own person or vocation from being a capital gain. This includes personal injuries, defamation, discrimination, harrassment and wrongful dismissal (para 210-220). In particular, I note that the ATO is prepared to include compensation:

(a) for injury arising not only through accident but also through illness (para 219-220).

(b) under *Wrongs Acts* which entitle a dependant to bring an action for the wrongful death of another. Even though it is not the recipient of the compensation that has died, the ATO accepts that the claimant has suffered a "wrong or injury... to his or her person" so that the compensation is free from CGT (para 215 of this ruling and TD92/130).

Differences Between Draft and Ruling

There are two main differences. The first is that excess recouped cost base amounts will not be taxable, whereas previously they were. This is compensation received where there is an underlying asset but there has been no disposal. The compensation is to be treated as a recoupment of the cost base on the underlying asset, but if the compensation exceeds the cost base on the underlying asset the excess is not taxable. This could be stunningly attractive. In the draft ruling the ATO wanted to apportion the compensation and treat the excess as being consideration on disposal of the compensation rights.

The other major change is to allow monetary losses into the cost base of the compensation rights. This means that there should be no gross-up problem with *Amadio* type claims. For instance, a guarantor could sue a solicitor because the guarantee was called up and the solicitor had not satisfactorily explained that signing a guarantee could cause such consequences. Previously there would have had to be a gross-up because the loss related to a payment, not an underlying asset. Now that guarantee payment can be included in the cost base for the compensation rights. This will mean that there is no CGT on the compensation receipt, and no need to claim an additional amount for tax on the damages.

Those who take out liability insurance will also find this principle important. They could have been taxed on receiving payment from an insurance company, as their indemnity rights would have been disposed of for the amount of the insurance receipt. Under this new interpretation, however, the insured will have a cost base equal to the amount of the insurance payment as it is a monetary liability that has triggered the insurance claim, and the amount of the monetary liability can be included in the cost base for the insurance rights. This means there will be no CGT on the indemnity receipt. If this had not been fixed up it would leave an insured person in an invidious position in that his or her insurance payout (after tax) would not be enough to pay the liability insured against.

What Anomalies Remain?

I think this ruling fixes 95% of the problems where there is a mismatch between the tax treatment of the compensation and the underlying subject matter of the compensation - so in 95% of cases the court would not have to increase the damages to allow for tax. However, the following difficulties (and probably others) still exist.

There are several annoying problems surrounding the treatment of compensation as a "recoupment of cost base".

The first of these recoupment problems is the fact that the claimant loses indexation by this treatment, and this could be enough to provoke a claimant to claim an amount for extra tax.

Our CGT system does not tax the inflationary element of a gain, and it does this by allowing the cost base of an asset to be increased by the CPI inflation index before calculating the capital gain. This is called "the indexed cost base". Unfortunately the recoupment provision in the Act (s160ZH(11)) does not permit the compensation to recoup the indexed cost base: it has to reduce the cost base, so the advantage of indexation is lost on that amount.

Treating compensation in this way will lead to higher tax in due course when the claimant does dispose of the underlying asset, and to fully compensate for the damage flowing from the wrong would have to include an element for this increase in tax.

The next problem is with the recoupment approach is to do with repairs. This is annoying in itself, and also has flow-on implications.

The ATO has decided you will be taxed on compensation for repairs unless you actually spend the money on the repairs - the rationale being that you won't have the repair expenditure available to recoup until then (para 135). This is uncommercial in that a person has never been obliged to actually repair the damage to be entitled to compensation for the damage, and it seems counter-productive to be creating yet another tax imperative to do something that is not ordinarily required.

Also, I think the requirement exhibits conceptual confusion. The cost of repair may well be the measure of the damages, but the damage has still been sustained whether it is repaired or not. If compensation for damage can ever be treated as recoupment of a cost base, then I can see no reason why it can't be treated in this way - especially when the ATO accepts that you can recoup an amount larger than your cost base.

This nitpicking on repairs unsettles me. It seems to indicate that taxpayers in receipt of compensation must run the gauntlet of the detail in the recoupment provisions.

I had taken this ruling as accepting that there would be a general regime of treating compensation received in respect of an underlying asset that has not been disposed of as a recoupment of the cost base, even if this required a fairly robust interpretation of specific provisions in particular cases. I thought that the ATO accepted that we needed this general rule as part of a package of measures to impose some order on this whole area, and that we would all conspire if necessary to turn a blind eye to difficult cases that fitted less neatly as recoupment than others.

Certainly the concession that excess recoupment is not taxable is evidence of the blind eye approach (para 133). If compensation for damage exceeds what you paid to acquire an asset, it is very difficult to see how all of that amount is a recoupment, and yet the ATO says not to worry about it.

The ruling therefore exhibits an unsettling ambivalence about whether the ATO accepts that all cases of compensation for an underlying asset without disposal are a recoupment of a cost base, or

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whether each taxpayer must make out his or her case, at peril of being taxable if not.

If there are any exceptions to the rule, the compensation will be taxed in full, leading to a situation where a gross-up claim can be made. This is because the fallback position is to treat the compensation as consideration for the disposal of the compensation rights, and the loss could not be included in the cost base of those rights as they did not involve payment of money or the giving of property.

Another situation where the ruling plainly contemplates compensation being taxable when it shouldn't be has to do with unapportioned or undissected compensation (para 188-209). The ATO has had an old score with undissected lump sums as they have sometimes sheltered income components from tax by inextricably mixing them with capital components. The ATO is visibly happy to take a position which puts the boot on the other foot.

Take a case where a car ploughs into a kiosk, causing the owner both property damage and personal injury. The personal injury component should be exempt, and the property damage should be a recoupment of the owner's cost base on the kiosk. This treatment, however, is dependent on being able to apportion the compensation between these two categories.

Problems here are avoidable, in that parties that are astute to the issue can make express allocations, and thus there is no compulsion on a judge to award grossed-up damages on this score alone.

For parties who do not turn their minds to the issue, there is a provision (s160ZD(4)) which allows an allocation of disposal consideration from another consideration on a reasonable basis (para 83-85). Strictly speaking, this provision can't allocate a compensation receipt between all of the categories relevant to its tax treatment, but I read the ruling as saying that the ATO will take a reasonably robust view about this and allow all elements to be allocated out if there is a reasonable basis for doing so (para 208).

If no allocation is possible, though, the ATO warns that it will have to resort to treating the compensation rights as the relevant asset, and the compensation as consideration for disposal of those rights. This, of course, means that there is ample opportunity for the compensation to be subject to CGT when it shouldn't be.

There appears to be a curious but potentially serious problem with motor cars, which are excluded from the definition of asset. Obviously compensation relating to motor car damage or loss should be treated in the same way as where there is an underlying "asset", except technically it isn't an "asset" and this might trip the ATO up in its own logic.

The ATO only feels justified in ignoring compensation rights as having any CGT consequences when there is a more appropriate "asset" that it can tie the compensation receipt to. With motor car compensation there is no other "asset", and the element of choice is missing.

Logically the ATO would be forced to treat the compensation rights as the relevant asset as there is no other "asset". This would result in the compensation becoming taxable because the ATO is only prepared to let the loss into the cost base when it is in the form of monetary payments or liabilities. Damage to or loss of a car does not fit that category, so the cost base of the compensation rights would be limited to the legal fees and other costs of prosecuting the claim.

On this basis, a gross-up of the claim would be necessary for the claimant to be adequately compensated after the compensation receipt is cut in half by aberrant CGT.

The ruling attempts to avoid a gross-up happening on car compensation by defining cars as "exempt assets" (para 3) even though they are not assets. The ATO admits that it has cribbed the logic here, but goes on to include cars with other things such as trading stock and principle residences which are exempt from CGT. Compensation is therefore also treated as exempt (see above).

Other Problems

The next problem is that the treatment is too complex. It still applies to every compensation receipt, and every recipient must assess whether he or she is part of the 5% minority that is adversely affected. There are two consequences of this:

1. Mistakes may be made by the non-tax practitioners who handle compensation situations daily. If the tax effect tests are not simple enough, a general understanding to one effect or another may grow up which is not correct in every case.
2. There will be micro-economic inefficiency and wastage. This follows from the fact that everyone will still need to remain vigilant that the CGT treatment of their compensation receipt will not cause aberrant or unexpected results. The process of exercising this vigilance must involve considerable complexity if the final ruling is 80 pages long.

It is probably no longer true that every court case will have an extra day added to argue the tax effect question on damages, but this won't be eliminated entirely. Specialist tax advice will be needed in a great many more cases than would be necessary if we had a more elegant or complete solution. Multiplied across a whole nation the effect is considerable.

There was one other potential interpretive approach that would have been a complete solution. It is a shame that the ATO dismissed it as blithely as they did (para 117-119 and 164), particularly when they have been prepared to stretch the issue on other points to get a sensible solution.

The argument is that advanced by Harper J in the *Carborundum case*[2]. He concluded that even if compensation rights are assets which are disposed of when compensation is received, there is nothing to be assessed because the compensation is not consideration for that disposal. He said the compensation is not an amount received "as a result of or in respect of" the compensation rights ceasing - it was paid "in respect of" the underlying loss that was the subject matter of the compensation. There is a certain attraction to both logic and the end result, if it is a total solution.

Where to from here?

The next step is probably to be taken by the Tax Law Improvement Project (TLIP)[3] which has just commenced its plain English re-write of the CGT provisions.

The government has shown no inclination to pass remedial legislation, and the ATO now thinks that the ruling is good enough to last until the plain English re-write. The ATO has said that it will not be recommending to the Government that there should be any remedial legislation ahead of this time.

Thus all eyes are on what the TLIP will do. Their difficulty is that they aren't meant to change any of the "policy" of the Act, or at least not any of the big"P" policy (we have witnessed a fair

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Capel Vale Wine, but which one for dinner?

Capel Vale's Vineyards are to be found two kilometres from the Indian Ocean on the banks of Capel River and also at Mount Barker, the only true cool climate region in Western Australia, and why Capel Vale also sources grapes from all over the south west.

Winemaker Rob Bowen says that the advantages of this geographical split is that a cooling south westerly breeze visits the temperate Capel River almost every afternoon.

This results in the vines "shutting down" so that growing and ripening takes place only in the mornings.

This longer ripening period contributes to the flavour build up of the grapes. By contrast the fruit from Mount Barker has different qualities, the soil is the oldest above sea level in the world. This, along with the cool ripening period, has the effect of producing intense flavours in the grapes.

When mixed and blended, the fruit from these regions form the basis of Capel Vale's well balanced premium wines.

This month we have selected a range of Capel Vale wines at special members prices for you to try.

Capel Vale Sauvignon Blanc Semillon

A traditional Bordeaux blend with the taste of each variety complementing the other.

Meal Tip

Ideal with seafood and salads.

$15.95 each

Capel Vale Chardonnay

Fashioned in the style of the great French white Burgundy.

Meal Tip

It is perfect to drink with foods of moderate flavour intensity including light meat dishes.

$18.50 each

1994 Capel Vale Shiraz

A vibrant, purple spicy shiraz, the winemaker secret recipe was to harvest the fruit from several vineyards rather than one.

Meal Tip

Ideal complement to meats and lightly spiced foods, ideal with roast lamb.

$16.55 each

1994 Cabernet Sauvignon

A medium bodied Bordeaux style is based on Cabernet Sauvignon from margaret River as well as a small amount of merlot from Capel.

MealTip

Ideal with red meat, particularly beef.

$16.55 each

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bit of little "p" policy being changed). TLIP is widely acknowledged to have a slightly freer brief with CGT than with other areas, as there are some real messes in there which they will have to contend with and hopefully fix up in the re-write.

The ATO believes it has given the TLIP team a guide as to the big "P" policy in its ruling, which is that we should avoid wholesale grossing-up of damages and blood in the streets (though perhaps they think a little of this is a good thing - I hope not).

I hope, however, that the TLIP team does not set about reproducing this convoluted, still somewhat leaky band-aid as the basis for their re-write. In my opinion the solution is to exclude rights to seek compensation from the definition of "asset" and do whatever is required to link the compensation to the underlying asset where there is one. In other words, we need to get to the English position. And to do this we would also need to exclude compensation receipts from the catch-all position (s160M(7).

In summary, the ruling is a creditable attempt to fix an absurd situation, but it is a band-aid approach, is convoluted, and wasn't as brave as it could have been in the interests of finding a total solution.

Notes

John Morgan is the tax partner with Phillip Fox's Melbourne office and has been involved in LIV Council sub-committee representations to Government in the ATO draft ruling.

1. 93 ATC 4293
2. 93 ATC 4424
3. Following the change of government after the March election, the fate of this project is not known. The Coalition policy is to "improve" the substance of the law, not just the words.

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