Capital Gains Tax Implications of Compensation Payments

G A BARTON†

The purpose of a compensation payment is to place the payee as nearly as possible in the position he or she would have been in but for the event for which the compensation is being paid. This article addresses the twin questions of whether and, if so, how the capital gains tax treatment of a compensation payment in the tax return of the payee is to be taken into consideration in achieving that purpose. Reference is made to the draft taxation ruling TR 94/D35 on the capital gains tax consequences of compensation receipts.

The provisions of Part III A of the Income Tax Assessment Act 1936 (Cth) ("the Act"), by which a net capital gain may be included in the assessable income of a taxpayer,[1] are based on a *voluntary* or *involuntary disposal* or *deemed disposal* [2] on or after 20 September 1985 of a relevant *asset*[3] acquired by the taxpayer on or after 20 September 1985.[4]

A post 19 September 1985 disposal of a relevant asset acquired by the owner/taxpayer after 19 September 1985 will trigger a Part III A calculation in the return of the taxpayer for the year in which the disposal occurs. Such a calculation may produce a capital gain, a capital loss or neither a gain nor a loss.[5] The amount of any capital gain is the excess of the consideration or deemed consideration on disposal of the asset over its permitted cost base.[6] A capital loss is the amount by which the asset's reduced cost base exceeds such consideration.[7] A compensation payment which, for the purposes of

† Associate Professor, The University of Western Australia. A shorter version of this paper was published in the journal of the Law Society of WA: (1994) 21(8) Brief 27.

1. S 160 Z0(1).
2. See generally s 160 M.
3. "Asset" is defined in s 160A; a reference to a disposal of an asset includes a reference to a disposal of part of an asset: s 160 R.
4. S 160 L. The provisions of Part III A have therefore been described as "transaction based" and "prospective".
5. This will occur where the consideration on disposal of the asset equals or exceeds its reduced cost base and is equal to or less than its cost base or indexed cost base: s 160 Z. It has been assumed that the disponer taxpayer is not exempt: s 160 Z (8), (9)(a), and that the asset was not used by the taxpayer solely for the purpose of producing eligible exempt income: s 160 Z (6), (9)(c), (10).
6. S 160 Z(1)(a).
7. S 160 Z(1)(b).

Part III A of the Act, constitutes consideration in respect of the disposal of an asset by the payee may therefore give rise to a Part III A calculation in the return of the payee for the year of the disposal.[8] The Commissioner of Taxation may in certain circumstances link the payment to an asset which the payee has retained and treat it either wholly or partially as a recoupment of cost for the purpose of any future disposal of that asset.[9]

Typically, a compensation payment will be made because the payer is under a legal obligation or perceived legal obligation to compensate the payee for loss of property, damage to property, personal injury, breach of contract or statute. Such payments may be made pursuant to a judicial or tribunal order at the conclusion of litigation or in terms of an agreement in settlement of the dispute. They may also be made routinely pursuant to a statutory entitlement or contract such as a policy of insurance.[10] The purpose of compensation payments is to place the payee as nearly as possible in the position he or she would have been in but for the event for which the compensation is being paid.[11] This article addresses the twin questions of whether and, if so, how the capital gains tax treatment of a compensation payment in the return of the payee is to be taken into consideration in achieving that purpose.

---

8. Compensation payments which are included in a Part III A calculation may be characterised as income pursuant to provisions of the Act outside Part III A. This paper does not include a discussion of the circumstances in which that might occur. In that event, however, resort may be had to s 160 ZA to reduce any capital gain to the extent that the payment is assessable other than as a recouped allowable deduction: TR 94/D35 ¶¶ 155, 156.
9. S 160ZH(11); TR 94/D35.
10. The scope of the pre-ruling Consultative Document issued by the Commissioner of Taxation in the matter of compensation payments and Part III A is stated to include payments arising out of:
    - litigation for damages (including negligence claims)
    - criminal compensation claims
    - civil suit claims
    - out-of-court settlements
    - breaches or variations of contractual arrangements
    - voluntary payments (eg by government departments)
    - personal damages (eg wrongful dismissal)
    - damages arising out of the loss or destruction of an asset
    - class actions
    - top-up payments (additional amounts awarded for the payment of any taxation liability).
11. *Livingstone v Rawyards Coal Co* (1880) 5 AC 25, 39 and *British Transport Commission v Gourley* [1956] AC 185, 197, in relation to a judicial award of compensatory damages. Not all awards are compensatory. If all that the plaintiff has proved is that a wrong or breach has occurred but has failed to prove any damage, the court may award nominal damages only. Damages may also be exemplary or punitive. The amount of a payment may be contractually fixed as in some policies of insurance: see generally *British Transport Commission v Gourley* id, 197-198, 206, 212.

THE GOURLEY PRINCIPLE

In *British Transport Commission v Gourley,*[12] the House of Lords held that in assessing damages for personal injuries resulting in a diminution of earning capacity, account must be taken of the tax the plaintiff would have paid had the lost earnings been received. In *Atlas Tiles Limited v Briers,*[13] a Bench of five High Court justices, two of whom dissented, declined to apply the *Gourley* principle in Australia in an assessment of damages for wrongful dismissal. Shortly thereafter the Full Court of the High Court in *Cullen v Trappell*[14] reinstated the *Gourley* principle for Australia by a majority of four to three in a matter concerning the assessment of damages for personal injuries. Most recently, in the quartet of *Provan v HCL Real Estate Ltd,*[15] *Tuite v Exelby,*[16] *Carborundum Realty Pty Ltd v RAIA Archicentre Pty Ltd* [17] and *Namol Pty Ltd v AW Baulderstone Pty Ltd* [18] the courts have been called upon to consider, in assessing damages, the capital gains tax treatment of the compensation payment in the hands of the plaintiff.[19]

1. Provan v HCL Real Estate Ltd

In *Provan*, the plaintiff alleged a breach of "contractual, common law and fiduciary duties"[20] by the defendant in relation to the sale by the plaintiff of a rental property acquired before 20 September 1985. Rolfe J awarded compensation for breach of a fiduciary duty and made a declaration that if the plaintiff was held liable to pay capital gains tax on the judgment the defendant would be bound to indemnify him for the amount so paid.[21] In

12. [1956] AC 185.
13. (1978) 144 CLR 202.
14. (1980) 146 CLR 1.
15. 92 ATC 4644.
16. 93 ATC 4293.
17. 93 ATC 4418.
18. 93 ATC 5101.
19. See also *Re Portman Place Building Units Plan (No 4313)* 94 ATC 4346. Although the purpose of the payment is generally to put the payee as nearly as possible in the financial position that would have obtained but for the wrong, transaction or event for which compensation is to be paid and is therefore to that extent antithetical to the concept of "gain" (see the opening remarks in the judgment of Harper J in *Carborundum Realty* supra n 17, 4420), that fact is not material to a technical application of the provisions of Part III A to the facts and circumstances which gave rise to the payment. It cannot "unwind" the disposals or deemed disposals which have triggered a capital gains tax calculation. In the case of certain payments, conditional statutory relief is provided such as the rollover relief in relation to insurance payments: ss 160 ZZK, ZZL.
20. Supra n 15, 4649.
21. The declaration is problematic as it refers to a liability to pay "capital gains tax" on the judgment, something which would only occur if a net capital gain for the purpose of s 160 ZO(1) arose in the return of the plaintiff which was solely referable to the judgment

the course of an extensive review of the authorities, his Honour concluded that if there is a liability to tax regard must be had to it. As he was unable to make any binding assessment of it, the question for the court was whether the plaintiff was entitled to recover the amount of any tax liability from the defendant. Furthermore, the declaration did not affront the principle that damages must be determined once and for all as that principle is subject to the qualification that liability may be considered in proceedings separate from those in which the damages are quantified.[22] The issue of whether the recovery of the judgment amount would trigger a Part III A calculation was disputed by the parties.[23]

2. Tuite v Exelby

In *Tuite*,[24] the Court concluded that the first plaintiffs were entitled to damages for the reduction in the capital value of certain shares and that "the matter of income tax on ... capital loss must be considered." The damages awarded were for breach of a restraint of trade covenant and Shepherdson J, after considering the provisions of Part III A, found it more likely than not that the first plaintiff's entitlement to the relevant damages awarded would lead to a Part III A calculation and that it was reasonably foreseeable by the defendants that their breach of the covenant would expose the plaintiffs to that liability. The court then increased the amount of the award and sought from the plaintiffs an undertaking in open court to refund to the defendants any amount of such increase which exceeded the tax assessed.[25]

3. Carborundum Realty Pty Ltd v RAIA Archicentre Pty Ltd

In *Carborundum Realty*, after the court had delivered its reasons for finding that the defendant was liable to pay the plaintiff damages as compensation for negligence in inspecting and reporting upon the condition of a residential property, which resulted in the plaintiff paying too much for the property, the plaintiff sought leave to amend its statement of claim to include a declaration that, if the plaintiff were liable to pay capital gains tax

---

payment and which, when included in assessable income, was not diminished by any allowable deduction and thus also constituted taxable income of the plaintiff. The declaration and indeed the judgment appear to proceed on the basis that the plaintiff's liability to pay capital gains tax is assessed separately from any liability to income tax: *Provan* supra n 15, 4652.

22. Id, 4647.
23. Id, 4645.
24. Supra n 16 (defendant's appeal to Full Sup Ct pending).
25. Id, 4299-4301; as in *Provan*, this approach apparently proceeds on the basis of a precise determination of the amount of tax referable to the compensation payment.

on the judgment, it would be entitled to be indemnified for such liability by the defendant.[26] The plaintiff had applied for and received a private ruling[27] that the damages awarded were a capital gain assessable to the plaintiff under Part III A.[28] As alluded to above,[29] Harper J declared that such a taxation consequence would frustrate the object of the judgment by levying capital gains tax on something which did not constitute a gain. The object of the award was to restore to the plaintiff the excess of the purchase price of the property over its market value at the time of acquisition. The court was of the view that the ruling was remarkable for it sought to apply Part III A to a disposal at no consideration[30] and which did not result in a gain. In consequence, the taxation liability was not within the contemplation of the parties, at the time they entered the contract, as the probable result of a breach[31] and was therefore too remote.[32] A further difficulty in the way of the court making an order to protect the plaintiff was that neither the liability to pay capital gains tax nor the amount, if payable, had been established.[33] A further reason for refusing leave to amend was the lateness of the application.[34]

4. Namol Pty Ltd v AIS Baulderstone Pty Ltd

In *Namol*, a case in which the plaintiff was awarded compensatory damages, aggravated damages and interest for breach of copyright, the court observed that adjustments of awards of damages for taxation ought to be made on proper evidence.[35] The approach of the common law to the assessment of damages is to award a fixed sum in the light of the probabilities

26. Supra n 17, 4419.
27. For the purposes of Part IV AA of the Taxation Administration Act 1953 (Cth).
28. Supra n 17, 4419.
29. Supra n 19.
30. The court regarded consideration, generally speaking, as something given by agreement in return for something else: supra n 17, 4424. It could not therefore be constituted by a judgment debt exacted compulsorily from someone who had not agreed to pay it and who would receive no consideration. This view is not accepted in TR 94/D 35 ¶¶ 73-75.
31. Therefore it did not fall within the principles in *Hadley v Baxendale* (1854) 156 ER 145.
32. The court considered that a similar result would arise in a claim in tort for negligence as the reasonably foreseeable damage caused by the negligence would not include a liability for capital gains tax.
33. The course of obtaining an undertaking in open court along the lines of that followed in *Tuite* did not commend itself to the court as such an undertaking may be refused: *Carborundum Realty* supra n 17, 4428; also the liability of the defendant would depend upon the outcome of litigation to which it was not a party: ibid. This problem also arises in relation to the approach taken in *Provan*. The court was also not sure that that approach did not affront the principle that damages must be determined once and for all and opined that the only means of avoiding the problem was to join the Tax Commissioner to the principal proceeding.
34. *Carborundum Realty* supra n 17, 4429.
35. *Namol* supra n 18, 5103. The court was of the view that there should be at least the

of the case and a conditional order is inconsistent with that principle.[36] The court did not accept that all judgments for compensation for loss resulting from the wrong or default of another would trigger a Part III A calculation as such a result is foreign to the context and purpose of the provisions.[37] Only awards reflecting compensation for a gain would have the same character as the gain and would therefore be subject to Part III A.[38] Furthermore, no adjustment for the capital gains tax need be made to awards for aggravated damages and interest as they are not compensatory in nature.[39]

The cases considered at 1.– 4. above demonstrate not only a difference of judicial opinion as to how a Part III A calculation ought to be accommodated in the assessment of the amount of compensatory damages but the need for the parties to such payments to know in advance how Part III A will apply to them. In the case of judicial awards, the courts making them cannot determine the application of the Act to them, and in the absence of agreement, the parties may have to lead expert evidence of the taxation issues. However meritorious the courts' observations may be in relation to economic gain and the purpose of Part III A, and however dismissive they might be of the opinion in a private ruling, those facts are of little comfort to the payee of an award which ceases to be adequate compensation because of the technical operation of the Act. This is especially so if it is finally determined that the principle whereby damages are assessed at law does not admit of the undertakings in open court and the declarations resorted to in *Tuite* and *Provan*.

The *Gourley* principle establishes the relevance of taxation to the application of the dominant rule of law that damages generally are compensatory.[40] The prevailing view was that the House of Lords ought not to be deterred from applying the dominant rule by the practice of the courts in not taking the tax position into consideration[41] and that it would be

---

opinion of an experienced tax practitioner as to the likely taxation consequences of the judgment and the basis for holding the opinion. Cf *Atlas Tiles Ltd v Briers* supra n 13, Stephen J, 234.

36. *Namol* supra n 18, 5103-5014.
37. Ibid.
38. Ibid. This view was supported by reference to *Zim Properties Ltd v Proctor* (1984) 58 TC 371.
39. *Namol* supra n 18, 5105.
40. Supra n 13, 208, 232-233.
41. Supra n 12. In forecasting and comparing the plaintiff's tax position with and without regard to the calamity for which compensation is to be paid, one is compelled to consider some of the indirect, rather than the direct, consequences of the calamity — something which the courts in a number of early decisions were not prepared to do. In *Fairholme v Firth & Brown Ltd* (1933) 149 LT 332, 333 the court refused, in assessing damages as between master and servant, to have regard to the servant's liability to the Crown "which is truly *res inter alios acta*"; see also *Jordan v The Limmer & Trinidad Lake Asphalt Co Ltd* [1946] KB 356; *Davies v Adelaide Chemical & Fertiliser Co Ltd* (1947) SASR 67;

out of touch with reality not to do so.[42] It rejected remoteness as a ground for disregarding the tax position in assessing damages.[43] Although the cases in which the principle has arisen involve a defendant seeking to reduce the amount of a compensatory payment, which the parties have agreed was wholly or substantially not assessable to tax in the hands of the plaintiff,[44] on the basis that the plaintiff would have paid tax on the lost earnings used to calculate the amount of the award, there is no reason of practice or principle why a plaintiff should not seek to increase the amount of a compensation payment because it is subject to tax but calculated by reference to losses otherwise not taxable.[45]

In the context of the capital gains tax provisions these conditions may be satisfied where the compensation payment is not exempt and is treated for tax purposes as consideration on the disposal or deemed disposal of a

---

Billingham v Hughes [1949] 1 KB 643; *Lincoln v Gravil* (1954) 94 CLR 430, 442; *Rought v West Suffolk* CC [1955] 2 QB 338; but contrast *M'Daid v Clyde Navigation Trustees* (1946) SC 462, 464.

42. Supra n 12, 202-203.

43. Id, 203. Lord Goddard rejected the mere fact that the item arises between the plaintiff and a third party as the test of remoteness; id 207, 212. Lord Keith delivered the only dissenting speech in which he made the point that it is a strange turn of fortune's wheel that the intricacies and accidents of fiscal legislation should have its repercussions in the assessment of damages in civil courts: id 216-218; cf the judgment of Barwick CJ in *Atlas Tiles Ltd v Briers* supra n 13, 211-212.

44. The operation of the *Gourley* principle in personal injury cases is not jeopardised by Part III A. A capital gain shall not be taken to have accrued to a taxpayer who receives a sum by way of compensation or damages for a personal wrong or injury or for a wrong or injury in his or her profession or vocation: s 160 ZB(1). The preliminary view of the Tax Commissioner is that this statutory exemption extends to an amount received in an out of court settlement where there is no admission of liability by either party: TR 94/D 35 ¶ 145. It is also the Tax Commissioner's view that the provision be read widely and that it embrace insurance monies under personal accident policies, compensation for libel, slander and defamation, employment and professional type claims including compensation for sexual harassment, discrimination, wrongful dismissal, loss of support following wrongful death and professional negligence in failing to institute a personal injury claim: TR 94/D 35 ¶¶ 146-148. The Tax Commissioner, however, would deny the exemption to a company and an individual trustee who receives compensation in that capacity: TR 94/D 35 ¶ 149.

45. Such a prayer was contemplated by Lord Goddard in *Gourley* supra n 12, 207. The principle has been stated to apply only where the earnings or profits lost would have been subject to tax in the hands of the plaintiff and the compensation payment is wholly or substantially not so assessable: *Robert v Colliers Bulk Liquid Transport Pty Ltd* [1959] VR 280; *Williamson v Commissioner for Railways* [1960] SR (NSW) 252; *Winkie Meatworks Ltd v Ballard* [1960] SASR 312; *Parsons v BNM Laboratories Ltd* [1964] 1 QB 95, 124-126, 133-135; *Groves v United Pacific Transport Pty Ltd* (1965) Qd R 62, 63; *Atlas Tiles Ltd v Briers* supra n 13, 220, 224, 227. Stephen J expressed the view that a judicious blend of principle and expediency, rather than conditions precedent, determine when, in the assessment of damages, the incidence of taxation be taken into account by the application of the *Gourley* principle: id, 235.

relevant asset but its amount was calculated by reference to another asset which was exempt or which was not disposed of by the plaintiff in the course of the calamity for which compensation is being made. This distortion arises because the claim which is satisfied, and therefore disposed of by the compensation payment itself (or the judgment debt, order or agreement which has preceded it) is an asset for the purposes of Part III A,[46] acquired by the plaintiff when it arose.[47]

THE AUSTRALIAN TAXATION OFFICE AND COMPENSATION RECEIPTS

The Tax Commissioner's draft ruling TR 94/D 35 on the capital gains tax consequences of compensation receipts proceeds on the basis that a compensation payment may be received by a taxpayer in respect of:

- the disposal or part disposal of or permanent damage to or permanent reduction in value of *an underlying asset*;
- an asset consisting of the *right to seek compensation*; and
- a *notional asset* pursuant to the provisions of section 160 M(7) of the Act.[48]

To the extent that the payment relates to an underlying asset it does not relate to a right to seek compensation or a notional asset for the purpose of section 160 M(7). Similarly, to the extent that it relates to a right to compensation, it does not relate to a notional disposal for the purpose of

---

46. The characteristics of an asset for the purposes of Part III A are to be found in s 160A. This section was materially amended with effect from 26 June 1992 to unequivocally include rights which are not proprietary. TR 94/D 35 is based on the view that a right to seek compensation was an asset for the purpose of s 160 A before 26 June 1992.
47. This is the view adopted in TR 94/D 35 ¶ 3. It is by no means certain that a right to seek compensation is disposed of when a taxpayer enters into a settlement agreement, as a personal chose in action may survive such agreement. The right to seek compensation is acquired at the time the damage, injury or breach occurs: TR 94/D 35 ¶¶ 102-104. This approach appears to be consistent with *Provan* supra n 15, 4652 and *Carborundum Realty* supra n 17, 4421. This aspect of the draft ruling is not stated to be based on any specific provision in Part III A. S 160 U(4) refers to a "change in ownership of the asset", something which does not occur when a taxpayer acquires a personal chose in action: *Hepples v Commissioner of Taxation* 91 ATC 4808, 4840. It is arguable that in respect of personal choses in action which arise after 25 June 1992, the defendant creates such right at the time of damage, injury or breach for the purpose of s 160 M(6) - (6D), thus producing the result contended for in the draft ruling.
48. TR 94/D 35 ¶ 52. S 160 M(7) is a residual provision which deems a relevant disposal to have occurred where the owner of an asset is entitled to receive money or other consideration because an act or transaction has taken place or an event has occurred in relation to the asset concerning its use or exploitation or, where it is a right, because the taxpayer has undertaken not to exercise it.

section 160 M(7).[49]

UNDERLYING ASSET

The draft ruling espouses the "look-through" approach, or "underlying asset" approach — a key term which is defined[50] as a process which requires an analysis of all the possible assets of the taxpayer in order to determine the asset to which the compensation amount is most directly related. Unfortunately the description of the term does not accord with its apparent meaning.

A technical analysis of all the possible assets of the taxpayer for the purposes of Part III A[51] would in many cases point to the right to seek compensation as the asset to which the payment is most directly related,[52] whereas what the Commissioner of Taxation is proposing, for the purpose of administering the Act,[53] is to "look through" that analysis to the asset (if any) which was the economic casualty of the calamity which gave rise to the compensatory payment. In Tax Determinations 31 and 57, taxpayers are told that where an asset or part of an asset is lost or destroyed the insurance payout or compensation payment is an amount of money received as a result of or in respect of that disposal for the purpose of section 160 ZD of the Act.[54] Harper J in *Carborundum Realty* remarked that no accountant seeking accurately to assess the plaintiff's financial position would treat the judgment debt in isolation but would link the money to the underlying asset.[55] This is what the Tax Commissioner proposes doing in the circumstances described below.

---

49. TR 94/D 35 ¶¶ 4, 7, 16, 17, 28. This sequence is derived from the draft ruling as a whole although ¶¶ 16 & 17 appear, in this regard, to be contradictory.
50. TR 94/D 35 ¶ 3.
51. In particular s 160 A as it relates to disposals after 25 June 1992.
52. This would not be so where payment is made by an agreement in which the payer has not admitted liability.
53. See generally TR 94/D 35 ¶¶ 53-63.
54. TR 94/D 35 ¶59. Despite the fact that the assessability of capital gains realised on insurance payouts is limited to amounts received in respect of assets the disposal of which would fall within the provisions of Part III A s 160 ZZH(3), the legislation does not provide that the payment shall constitute the consideration for the disposal or part disposal of the insured asset. Where an insured asset is lost, destroyed or damaged and an insurance payment is made, technically two disposals for the purposes of Part III A occur — one in respect of the insured asset, s 160N, and one in respect of the contractual right under the policy which was satisfied by the payment: s 160 (M)(3)(b); cf *IRC v Montgomery* [1975] Ch 266.
55. Supra n 17, 4421; TR 94/D 35 ¶ 61; if the compensation may be linked to more than one asset, then the most relevant assets must be determined and the payment apportioned between them in accordance with s 160 ZD(4); TR 94/D 35 ¶¶ 13, 64-66.

APPLICATIONS OF THE UNDERLYING ASSET APPROACH

1. Disposal or part-disposal of an underlying asset

If a disposal or part-disposal of the underlying asset has occurred then, using the general provisions of sections 160 M and 160 N, the compensation payment is the consideration received for that disposal and the taxpayer is entitled to any rollover relief or exemption applicable to the asset,[56] including that provided by section 160 ZZR in relation to goodwill.[57]

2. Permanent damage to or permanent reduction in the value of the underlying asset

The draft ruling introduces a concept of permanent damage to or reduction in value of the underlying asset. This key term does not mean "everlasting" damage or reduced value but refers to damage or a reduction in value which will have a permanent effect unless some action is taken by the taxpayer to put it right.[58] Where a taxpayer receives a compensation payment in respect of such damage or reduction in value to a post 19 September 1985 underlying asset the payment is to be treated as a recoupment of all or part of the unindexed acquisition cost or deemed cost base of the asset for the purpose of section 160 ZH(11) as if the cost had not been incurred.[59] Any excess is treated as the consideration for the disposal of the right to seek compensation or of a notional asset and an immediate capital gains tax liability may arise.[60] A compensation payment in respect

56. TR 94/D 35; TD 15; TD 93/182; TD 93/178. It should be noted at the outset that the draft ruling is based on the view that the words "as a result of or in respect of the disposal" in s 160 ZD(1)(a)(b) and (c) are sufficiently broad to include as "consideration" an amount compulsorily exacted and for which the payer has received nothing in exchange: see *Carborundum Realty* supra n 17, 4424; TR 94/D 35 ¶¶ 73-75.

57. TR 94/D 35 ¶ 158; IT 2328. Presumably in a case such as *Provan* supra n 15, the Tax Commissioner would treat the compensation payment as part of the consideration on disposal of the pre-20 September 1985 rental property and the *Gourley* principle would be inapplicable to its calculation.

58. TR 94/D 35 ¶ 3. Similarly, compensation for the grant of an involuntary easement which causes a permanent reduction in the value of the land may be applied to reduce the cost of the land *provided the amount is reduced by the amount of legal costs*: TR 94/D 35 ¶¶ 12, 180-182.

59. TR 94/D 35 ¶¶ 6-8, 78-84, 93-99. A cost base reduction is not permitted for temporary fluctuations in the value of goodwill: TR 94/D 35 ¶¶ 159-162.

60. TR 94/D 35 ¶¶ 7, 15, 84, 100-101. The compensation payment in *Tuite* supra n 16, relating as it did to post 19 Sept 1985 shares, would therefore give rise to a Part IIIA calculation to the extent that it exceeded the cost base of the shares. The *Gourley* principle would not apply, however, because the loss amount would have triggered a Part III A calculation had it been realised by the plaintiff.

of a pre-19 September 1985 underlying asset or an exempt asset is not subject to Part III A even where the compensation amount exceeds the cost of the asset and the damage or reduction in value occurred after 19 September 1985.[61]

3. Disposal of the right to seek compensation

Where there is an underlying asset and the right to seek compensation, and there has been no disposal of or permanent damage to or reduction in value of the underlying asset, then the compensation is received for the surrender of the right to seek compensation. In this event the *Gourley* principle would not apply because the compensation payment is for an amount which would have been subject to Part III A (particularly section 160 M(7)) or, as in *Namol*,[62] income according to ordinary concepts, had it been derived by the plaintiff. Where the compensation payment has been received partly in respect of damage or reduction of value the excess is received for the right to seek compensation.

4. Compensation for excessive consideration

Where a taxpayer is compensated for having paid an excessive amount to acquire an asset as in *Carborundum Realty*, the payment is to be treated as a recoupment of all or part of the original acquisition cost for the purposes of section 160 ZH (11).[63] The *Gourley* principle would therefore not apply as the compensation receipt would not give rise to a Part III A calculation but rather a cost base adjustment in relation to a future disposal of the affected asset.

CONCLUSION

TR 94/D 35 is a draft taxation ruling and as such may not be relied upon by taxpayers. Once it is issued as a public ruling reflecting the opinion of the Commissioner of Taxation as to the application of Part III A to compensation payments, it may facilitate agreement between parties as to the capital gains tax treatment of a particular compensation amount because it is to their taxation advantage to submit to his view. This in turn will obviate the need for proper evidence of the kind mentioned in the *Namol* decision.[64] The approach which the Taxation Commissioner proposes to adopt, however, is not based on a technical application of the provisions of

61. TR 94/D 35 ¶¶ 9, 11, 49, 51.
62. Supra n 18.
63. TR 94/D 35 ¶ 10; *Carborundum Realty* supra n 17.
64. Supra n 18, 5103.

Part III A and until the legislation is amended to reflect the underlying asset approach a court might conclude that the ruling is "contrary to law". But to the extent that it is accepted as reflecting the capital gains tax treatment of compensation payments, it will in many cases negate the argument that Part III A compromises the compensatory character of the payment.

It is essential that a composite compensation payment be itemised or that its components may be reasonably estimated, failing which the Taxation Commissioner will treat the whole amount as relating to a disposal of the right to seek compensation.[65]

In those cases where the *Gourley* principle requires that the application of Part III A to a compensation payment be taken into account in applying the dominant rule of law, the question arises as to how the taxation issue is to be accommodated. In *Namol,*[66] Davies J held it to be inconsistent with common law principles to make a conditional order either providing for an additional payment should a certain event occur,[67] or a reduction of the award should that event not occur.[68] Some of the practical problems associated with such an order have been adverted to above. The draft ruling proceeds on the basis that section 160 ZD (1) is wide enough to include the judgment debt, presumably in its entirety.[69] Consideration would therefore include "top-up" payments,[70] interest and exemplary damages. Where the judgment includes an indemnity of the kind in *Provan*[71] one would have to value the indemnity as a component of the compensation payment or treat it as an asset which is disposed of on indemnification.[72] These practical difficulties do not warrant a departure from the rule that damages be awarded in a fixed sum or sums even if this entails an estimate of the probable taxation liability along broad lines.[73]

---

65. TR 94/D 35 ¶¶ 124-142; esp ¶ 139.
66. Supra n 18, 5104; see also *Carborundum Realty* supra n 17, 4429.
67. As was the case in *Provan* supra n 15.
68. As occurred in *Tuite* supra n 16.
69. TR 94/D 35 ¶¶ 71-77 & 107.
70. TR 94/D 35 ¶¶ 167-173.
71. Supra n 15.
72. This issue is not addressed in TR 94/D 35.
73. *British Transport Commission v Gourley* supra n 12, 203, 208, 212, 215; *Atlas Tiles Ltd v Briers* supra n 13, 227, 233, 237.