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PUB00246: Income Tax - Treatment of lump sum settlement payments

Introduction

1. The New Zealand Law Society (Law Society) appreciates the opportunity to comment on the draft Interpretation Statement PUB00246: *Income Tax – Treatment of lump sum settlement payments* (Exposure Draft).

Summary

2. The Exposure Draft considers how the Commissioner will treat a lump sum payment received under a settlement agreement for claims that (if successful) would have resulted in receipts both capital and revenue in nature.
3. The Exposure Draft states at paragraph 3 that where a single undissected settlement sum is received, it should be apportioned between its capital and revenue elements where possible. Apportionments must be made on an objective basis, taking into account the settlement agreement, related documents, the circumstances surrounding the agreement and other relevant evidence. This proposed approach appears consistent with the position taken by New Zealand courts to date.
4. The Exposure Draft specifies at paragraphs 3 and 4 that the onus of proof is on the taxpayer to show that the apportionment is appropriate. Where the taxpayer fails to discharge the burden of proof upon him or her to apportion the lump sum payment, the amount will be considered as a whole. In such a case, the Commissioner proposes that the full amount be treated as income unless the income part is so ancillary or incidental that it can be ignored.
5. The Commissioner's rationale for the proposed position is that some taxpayers have taken the view a lump sum should be treated as wholly capital and, therefore, not subject to income tax. This view appears to be based on two Australian High Court cases, *McLaurin v FCT* (1961) 12 ATD 273 and *Allsop v FCT* (1965) 14 ATD 62.

6. The Law Society does not agree with the Commissioner's approach to adopt a default position in the event a taxpayer is unable to discharge the burden of proof with respect to apportionment. Rather than provide for a default position, the Law Society recommends that the Exposure Draft should clarify for taxpayers the elements the Commissioner considers are relevant for the purposes of determining the issue of apportionment and the evidence required by the taxpayer to support their position.
7. The Exposure Draft provides a reasonably detailed analysis of the judicial approach to the issue of apportionment by the courts in New Zealand, Australia and the United Kingdom. As such, based on the analysis given, it should be possible for the Commissioner to outline the evidence she considers relevant for New Zealand taxpayers to discharge the burden of proof when apportioning a lump sum settlement payment between capital and revenue.

Analysis of case law on apportionment

8. The approach of the New Zealand courts has been to apportion where possible rather than adopt an 'all or nothing' approach.¹ In determining the character of a settlement payment, the New Zealand courts have considered all available evidence including the statement of claim, mediation agreement, settlement agreements and surrounding circumstances of the case.² As stated in paragraph 24 of the Exposure Draft: "*the New Zealand courts have tended to take a broad approach to apportionment*" and "*the Courts will apportion where there is a reasonable basis for doing so*". No default position has been proffered. The Law Society agrees with this approach.
9. The approach of the UK courts has also been to apportion a lump sum settlement where possible. While the New Zealand courts have looked at a range of evidence to determine the matter, the UK courts have considered the issue of apportionment on the basis of whether it is possible objectively to calculate the respective values of the rights given up in return for a lump sum payment. In the two cases cited in the Exposure Draft (*Wales v Tilley* [1943] 1 All ER 280 (HL) and *Carter v Wadman* (1946) 28 TC 41 (UKCA)) the court gave no consideration to any agreement between the parties as to how the payment was made up. The focus was on apportioning the payments based on the respective values of the rights that were given up in return for the lump sum payment.
10. The Exposure Draft illustrates that the position adopted by both the New Zealand and UK courts contrasts with that taken by the Australian courts. In the case of *McLaurin*³ the High Court of Australia took the view that it is appropriate to apportion a single payment of a mixed nature made in settlement of specified claims where at least some of the claims are for a liquidated amount or are amounts that are "otherwise ascertainable by calculation". The court considered that apportionment was not appropriate where a payment is made only for claims for unliquidated damages under a compromise that treats payment as a single undissected payment. In such circumstances the amount must be considered as a whole.

¹ Buckley v Young Ltd v CIR (1978) 3 NZTC 61,271.

² Case V8 (2001) 20 NZTC 10,092.

³ McLaurin v FCT (1961) 12 ATD 273 (HCA).

11. The Australian courts (unlike the New Zealand and UK courts) when considering the issue of apportionment have been predominantly concerned with establishing what the parties had agreed the amount was paid for, rather than what one party had originally claimed the payment was for.
12. In *Allsop*⁴ the High Court of Australia looked for evidence as to how the parties calculated the amount of the settlement payment (i.e. what they agreed the amount was for) rather than attempting to value the respective claims given up. In that case the agreement contained a general release clause covering all potential claims, and as such it was not possible for the court to determine that any specific amount was paid for any specific claim. Therefore, the court found the whole amount should be treated as capital.
13. It is noted that neither *McLaurin* nor *Allsop* has been applied in New Zealand. Paragraph 51 of the Exposure Draft states the Commissioner's view that, to the extent *McLaurin* and *Allsop* stand for the proposition that where an undissected settlement payment includes both capital and revenue amounts the whole amount is treated as capital, such an approach would not be followed in New Zealand. It is unclear in the Exposure Draft whether the Commissioner's view is based on the method adopted by the Australian courts in assessing the issue of apportionment (i.e. focusing predominantly on what the parties agreed the payment is for as opposed to other evidence such as the statement of claim or related documents) or the overall default proposition that if apportionment cannot be made, the entire amount should be treated as capital.
14. Similarly, while the Exposure Draft provides a detailed analysis of the different approaches taken by the courts in New Zealand, the UK and Australia, there is no apparent explanation (other than a reference at paragraph 60 to a statement from *Buckley v Young*) for the Commissioner's position that if a taxpayer is unable to show what part of a lump sum payment is capital, the whole amount should be treated as income.
15. In the Law Society's view, the analysis of approaches taken by the courts in New Zealand, the UK and Australia suggests the difference in the approach is not necessarily in adopting a default position if apportionment cannot be made, but rather the elements the court considers relevant when determining the issue of apportionment.

Recommendation

16. The Law Society considers the Exposure Draft would be of greater benefit to taxpayers if it provided a more detailed analysis of the matters the Commissioner considers are relevant (and not relevant) when determining on an objective basis the issue of apportionment, rather than proposing an overall "default position". Using the case law examples given, it appears that it is possible for the Commissioner to formulate a more detailed guide in the Exposure Draft as to the elements the Commissioner considers are relevant for assessing the issue of apportionment and ultimately discharging the taxpayer's burden of proof.
17. It is noted that no real consideration has been given to the difference in treatment between claims for liquidated damages and unliquidated damages. Case law appears to indicate that

⁴ *Allsop v FCT* (1965) 14 ATD 62 (HCA).

where a claim is for liquidated damages it is usually possible for apportionment to be made between the elements that comprise of capital and revenue. However, where a claim has been made for unliquidated damages, the approach of the courts has been to treat the payment as a whole. It is unclear why the Commissioner has concluded that in the event an amount cannot be apportioned the entire amount should be considered as income. Such a position seems to ignore the basis of the claim which resulted in the settlement payment and is inconsistent with the proposed position relating to apportioning lump sum payments generally.

Conclusion

18. This submission was prepared with assistance from the Law Society's Tax Law Committee. If you wish to discuss this further, please do not hesitate to contact the committee's convenor Neil Russ, through the committee secretary Jo Holland (04 463 2967 / jo.holland@lawsociety.org.nz).

Yours sincerely

A handwritten signature in black ink, consisting of a stylized initial 'C' followed by a long horizontal line.

Chris Moore
President