Inland Revenue
Te Tari Taake

INTERPRETATION STATEMENT: IS 20/01

INCOME TAX – TREATMENT OF THE RECEIPT OF LUMP SUM SETTLEMENT PAYMENTS

All legislative references are to the Income Tax Act 2007 unless otherwise stated.

Contents

Summary

1. The focus of this statement is setting out how the Commissioner will treat a lump sum payment received under a settlement agreement for claims that (if successful) would have resulted in receipts of both a capital and revenue nature.

2. Whether a settlement payment is taxable depends on what it is paid for – in this case, what was given up in return for the payment – and its nature in the hands of the recipient. It is essential to first determine what a payment is for before determining whether apportionment is necessary.

3. It has been suggested that two High Court of Australia decisions: *McLaurin v FCT* (1961) 12 ATD 273 and *Allsop v FCT* (1965) 14 ATD 62 *McLaurin* and *Allsop* are authority for the proposition that, if an undissected settlement payment includes both capital and revenue amounts, the whole amount will be treated as capital. To the extent that *McLaurin* and *Allsop* stand for this proposition, the Commissioner's view is that they would not be followed in New Zealand. Rather, where possible, New Zealand courts would seek a reasonable basis for apportioning a lump sum.

4. Given this, where a single undissected sum is received, it should be apportioned between its capital and revenue elements where possible. Any apportionment must be made on an objective basis. The starting point for determining an appropriate apportionment will be the settlement agreement and any related documents (for example, the statement of claim (if there is one)). Where necessary, the circumstances surrounding the agreement and other relevant evidence (such as evidence of any negotiations between the parties) should be considered. The onus of proof is on the taxpayer to show the apportionment is appropriate.

5. In the rare circumstance where the payment cannot be appropriately apportioned, the whole amount should be treated the same. Where the lump sum includes an

amount that is taxable under a provision in Part C, the taxpayer has the burden of proving what part of the amount is not taxable. If a taxpayer is unable to show what part of a lump sum payment is capital, the Commissioner's view is that generally the whole amount should be treated as income.

Introduction

6. We have been asked to clarify the Commissioner's position on how to treat lump sum payments made to settle claims partly capital and partly revenue in nature. There has been uncertainty as to how such payments should be treated. In particular, some people have taken the view that the lump sum should be treated as always wholly capital and, therefore, not subject to income tax. This is based on an interpretation of two High Court of Australia decisions: *McLaurin v FCT* (1961) 12 ATD 273 and *Allsop v FCT* (1965) 14 ATD 62. This item sets out the Commissioner's view on this issue.

Analysis

How to determine whether an amount is capital or revenue

7. To decide whether a payment is capital or revenue, it is necessary to determine what the payment is for (*Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 (CA)). The character of a cause of action discharged by a payment will determine the nature of the payment (*Federal Coke Pty Ltd v FCT* 77 ATC 4255 (FCA)). Therefore, where a payment is received in return for settling claims, it is necessary to consider what the nature of any payment received would have been if those claims had been successful. A payment received to settle claims of a revenue nature would be revenue. A payment received to settle claims of a capital nature would be capital (*Case V8* (2001) 20 NZTC 10,092). This is regardless of the nature of the legal rights to make the claims for payment – that is, whether made in contract or tort or under statute or in any other way in which a right to claim may arise (*London & Thames Haven Oil Wharves Ltd v Attwooll* [1967] 2 All ER 124 at 134 per Diplock LJ).

8. Sometimes a payment will be made to settle claims of both a capital and revenue nature. As discussed below, in the Commissioner's view, generally such payments should be apportioned. An exception to this is where one of the advantages sought is ancillary or incidental to the other. In such a case it may be proper to characterise the payment as wholly capital or wholly revenue (*Buckley & Young* (at 61,275):

> Difficulties of characterisation may arise where the director or employee agrees to resign and to give a restrictive covenant. **The proper conclusion may be that the payment secures one advantage and the other provision is merely ancillary or incidental, not affecting the character of the payment** (cf. *Anglo-Persian Oil Company Limited v Dale (H.M. Inspector of Taxes)* [1932] 1 K.B. 124, 139-140). In other cases distinct and separately identifiable advantages may be gained by the payment. There the payment is of a dual character. The statement of the problem highlights the importance of identifying the true character of the payment for which deduction is sought. [Emphasis added]

In that case, it would not be necessary to go on and consider apportionment.

9. For an amount to be taxable, it must be "income" under a provision in Part C (and not exempt or excluded income). In the context of settlement payments, common provisions that could apply include s CB 1 (amounts derived from business) and s CE 1 (amounts derived in connection with employment). Unless the context otherwise requires, references to "revenue" amounts in this statement assume that a provision in Part C would apply to treat the amount as assessable income.

10. At issue is the tax treatment of a lump sum paid to settle claims of both a capital and revenue nature.

Apportionment

New Zealand approach

11. The Commissioner considers the approach of the New Zealand courts is to seek to apportion a payment into its capital and revenue elements wherever possible. This is demonstrated in Richardson J's judgment in *Buckley & Young* – one of the leading New Zealand cases on apportionment. Although *Buckley & Young* considered the apportionment of expenditure rather than income, in the Commissioner's view the same principles are relevant to both. *Buckley & Young* shows the approach of the New Zealand courts is to apportion where possible, rather than applying an all-or-nothing approach. However, an all-or-nothing approach can arise where the taxpayer fails to provide a reasonable basis for apportionment.

12. *Buckley & Young* concerned a series of agreements aimed at removing an unsatisfactory employee. The payments made were for both capital (restrictive covenant) and revenue (payment made to remove employee) elements. The contract did not specify how the amounts paid were to be apportioned.

13. Richardson J noted that the purpose of apportionment is to determine how much of an amount the parties have attributed to a particular item. This is done by considering the terms of the contract and, where relevant, the context and background to the agreement. Richardson J took the view that a situation where apportionment was impossible was likely to be rare and the fact an apportionment might be difficult was not, of itself, a reason not to apportion.

14. He also noted that "absolute precision" was not required, nor was it necessary that the apportionment could be "calculated by some kind of scientific process". Apportionment cannot, however, be based on mere speculation and there must be sufficient evidence to justify the result. Ultimately, apportionment was not possible on the facts of that case as the taxpayer had not put forward any argument as to how apportionment should be made.

15. *Case V8* considered the characterisation of a lump sum settlement payment. In that case, the taxpayer (the operator of a kiwifruit packhouse and storage facility) had filed a statement of claim alleging breach of contract by the supplier and manufacturer of an allegedly defective fruit-processing machine, misrepresentation and negligence. The taxpayer claimed compensation of $1,050,561.25. Mediation resulted in an out of court settlement under which the taxpayer received $170,000 from the designer of the machine and $100,000 from the manufacturer. The agreement included a denial of liability by all parties. It was also entered into in "full and final settlement of all issues between the parties in or in connection with" the proceedings.

16. Judge Barber considered that in determining the character of the settlement payment it was necessary to consider the statement of claim, the mediation agreement, the settlement agreement and the circumstances surrounding the case. As the mediation agreement referred to the attached settlement agreement and the statement of claim, these documents were intended to be read together. Judge Barber considered that the settlement payment was made to compensate the taxpayer for the losses specified in the statement of claim.

17. The taxpayer argued that, because the payment was received as a lump sum, it could not be apportioned between the ingredients of the original claim made by

the taxpayer. Judge Barber held that, as the payment was made to compensate the taxpayer for loss of profits and for repair costs as per the statement of claim, the settlement payment was income, being compensation for revenue losses. The judgment suggests that if it had been established that the settlement payment was compensation for losses of both a capital and revenue nature, apportionment would have been required. Unlike in *Allsop* (considered in more detail below), the fact that the agreement included a general clause settling all issues between the parties was not seen as relevant – even though there may have been capital claims that the taxpayer could have (but did not) bring. Foregoing the right to sue was an incident of settlement; it did not characterise the payment.

18. *Case S96* (1996) 17 NZTC 7,603 related to personal grievance proceedings against an employer. The settlement agreement had been lost so the Taxation Review Authority had to consider whether (and how) a lump sum settlement payment should be apportioned (between revenue amounts (for loss of income) and capital amounts (for humiliation, loss of dignity and hurt feelings)). The taxpayer argued that the entire settlement payment was compensation for injury to feelings.

19. Judge Barber considered all of the available evidence and circumstances and chose to apportion the payments on a pro rata basis of the amounts claimed in the original proceedings. In his view, this was a fair apportionment (at 7,608):

> I consider that the non taxable element of the settlements needs to be now fixed by this Authority because it has heard the available evidence, and **regardless of what limit may have been imposed by the Settlement Agreement**. **The issue must be what, in commercial and personal reality, was a fair apportionment of each settlement to compensation for feelings injury**. [Emphasis added]

20. *Sayer v CIR* (1999) 19 NZTC 15,249 involved an employment court award for wrongful dismissal. The Employment Court awarded Mr Sayer compensation including $62,142 as compensation for lost remuneration, $50,000 for humiliation, loss of dignity and injury to feelings and $5,000 for costs (a total of $117,142). Mr Sayer applied to wind up the company and also took action against the directors and shareholders of the company for any shortfall that he might suffer as a result of the company's liability to him, as well as interest and exemplary damages.

21. Mr Sayer entered into a deed of settlement and assignment with the directors and shareholders of the company. At that time, the company owed Mr Sayer $130,944.30. Under the deed of settlement, in consideration of the amount of $100,000, Mr Sayer agreed to assign to a second company all claims that he might have against the company and to release the directors and shareholders from any claims that he had against them. The deed provided that $99,999 of the settlement amount (together with interest less withholding tax) was attributable to the consideration for the assignment of Mr Sayer's claim against the company.

22. The Commissioner had assessed $50,000 as monetary remuneration and had attributed the other $50,000 to compensation for humiliation (capital). Mr Sayer argued that no part of the $100,000 was monetary remuneration as it was paid to bring about the discontinuance of his proceedings against the directors and shareholders (rather than to settle his dispute with the company). However, Doogue J considered that the deed of settlement made it clear that $99,999 of the settlement amount (together with interest less withholding tax) was attributable to the consideration paid for the assignment of the claim against the company and that it was not possible to go behind the deed.

23. The taxpayer also argued that the $100,000 could not be apportioned and must be considered as a whole. This was on the basis of *McLaurin* and *Allsop* (which are considered below). Doogue J rejected the taxpayer's argument on the basis that it was not supported by the facts and distinguished *McLaurin* and *Allsop* on the basis that the settlement agreement in *Sayer* involved settling a claim for liquidated damages (which was squarely within one of the exceptions noted in *McLaurin*).

24. In *Henwood v CIR* (1995) 17 NZTC 12,271 the majority of the Court of Appeal (Richardson J and Hardie Boys J) held that payments received under a contract for services were partly capital in character as the payments were received in return for both acting services (income) and for the restraint of trade (capital). The majority also held the payments could be apportioned.

25. In determining an appropriate apportionment, Richardson J was willing to take into account the TRA's finding as to what level of fee would have been commercial in the circumstances (ie attributing a value to that element of the contract). This, in conjunction with implications from the contract, provided the basis for Richardson J's conclusion that the TRA's apportionment was appropriate.

26. On the other hand, Hardie Boys J appears to have been trying to work out from the contract how much the parties intended to allocate to each element (which he found in clause 11 of their contract). In the absence of any indication to this effect, Hardie Boys J suggested that apportionment may have been impossible.

Conclusion on New Zealand approach

27. The New Zealand courts have tended to take a broad approach to apportionment. The default position is that the courts will apportion where there is a reasonable basis for doing so. In determining an appropriate apportionment, the courts have looked at the documentation between the parties, as well as the relevant context and background.

United Kingdom case law

28. Two United Kingdom cases directly on point are *Wales v Tilley* [1943] 1 All ER 280 (HL) and *Carter v Wadman* (1946) 28 TC 41 (UKCA). Both cases considered the apportionment of undissected lump sum settlement payments.

29. *Wales v Tilley* was a decision of the House of Lords (which was followed by the House of Lords more recently in *Mairs (Inspector of Taxes) v Haughey* [1993] 3 All ER 801). It concerned the managing director of a company. The company had agreed to pay Mr Tilley a salary of £6,000 a year and had also agreed to pay him a pension of £4,000 a year for 10 years after he ceased to be managing director. Mr Tilley agreed to release the company from the obligation to pay the pension and agreed to a reduced salary of £2,000 a year in consideration for a lump sum payment of £40,000 in two equal instalments.

30. The House of Lords held that, to the extent the payment was received for surrendering a right to a pension, it was capital and, to the extent the payment was made in consideration of a reduction of salary, it was income. There was nothing in the agreement that apportioned the amount between the two rights that had been surrendered. Nor was there any other evidence of agreement between the parties as to how the amount was calculated.

31. Viscount Simon noted that if the court considered tax was due under one head but not the other, the Attorney-General, on behalf of the Crown, had accepted the amount should be treated as apportionable. On the same point, Lord Thankerton commented that, on the issue of practicability, Mr Tilley's accountants had

provided a basis for apportionment. Lord Porter considered that although there were difficulties in determining the amount attributable to each component (which depended, for example, on when Mr Tilley's employment ceased), it was not impossible to do so (at 285):

> It only remains, therefore, to see whether the sum attributable to the release of the pension can be separated from that payable for the reduction of salary. It was only faintly argued on behalf of the Crown that such a division was not possible; but it was said that there were no materials **upon which such a calculation could be made** inasmuch as the cessation of the salary and the commencement of the pension were dependent on many unascertainable matters, amongst others on the Appellant's choice of the time of his retirement. No doubt there are difficulties but the resultant figure **seems no more incalculable** than, say, the length of time during which an injured workman would have continued to earn wages had he not received his injury, a period difficult no doubt to ascertain, but one which has constantly **to be estimated** in dealing with cases of personal injury. [Emphasis added]

32. Therefore, in considering whether an apportionment was possible, Lord Porter considered whether it was possible to objectively calculate the respective values of the rights given up in return for the lump sum payment. The fact the respective amounts would have to be estimated (as they could not be calculated exactly) did not mean apportionment was not possible. The case was referred back to the Special Commissioners to determine the appropriate apportionment.

33. A similar issue was considered by the UK Court of Appeal in *Carter v Wadman*. In that case, the taxpayer (Mr Carter) was employed as the resident manager of a public house for a salary of £10 per week plus a quarter share of the net profits of the business. The term of the agreement began on 30 January 1942 and ended on 24 June 1949. In 1942 the employer (Mrs Pierce) wished to assign the lease and the licence for the premises and to sell the goodwill, chattels and stock relating to the premises. Mr Carter's consent to the assignment was required as it was a term of Mr Carter's agreement with Mrs Pierce that she could not, without his consent, sublet or part with possession of any part of the premises or the goodwill or assets of the business, except in the ordinary course of business.

34. Mr Carter and Mrs Pierce entered into an agreement under which Mrs Pierce agreed to pay Mr Carter £2,000 in consideration of his agreeing to the transfer of the licence to the purchaser and in full settlement of "all past, present and future claims" he might have against her under the management contract. At the time the agreement was made Mr Carter had been paid his salary up to the cancellation date (2 December 1942), but his share of the profits for the 1942 year had not been calculated. In view of the agreement, Mr Carter could no longer make any claim against Mrs Pierce for a share of the profits. Subsequently, it was determined that Mr Carter's share of the profits would have been £1,090.

35. The Court of Appeal had to determine whether any part of the £2,000 was employment income. It considered the payment was, in part, the price for the cancellation of the agreement and, in part, paid in settlement of past and present claims. One of the possible claims was for the taxpayer's share of the profits up to 2 December 1942 (this would be employment income). The court considered it was possible to determine the value of the unexpired term of the agreement, at 52-53:

> Mr. Mustoe sought to argue that, as the consideration was one lump sum of £2,000, it was impossible to point to any portion of the £2,000 and say that it was a profit arising from his employment: but the Crown might equally well have argued that, as it was impossible to fix any sum which represented a capital payment, the whole must be income. … **But we respectfully agree with their Lordships** [in *Wales v Tilley*] **that in principle there must be apportionment, and we think that on the facts of the present case, though the calculation of the value to the Appellant of the unexpired portion of the agreement must be a matter of estimate, there is no insuperable difficulty in estimating its**

value. [Emphasis added]

36. It can be seen from this that the court was concerned with apportioning the lump sum based on the values of the respective elements. Consistent with *Wales v Tilley,* there was no consideration given to trying to determine any agreement between the parties as to how the amount was made up. This emphasis on valuation is consistent with the order the court gave regarding apportionment when referring the case back to the General Commissioners.

37. The court found apportionment should be made on the basis of the proportion the sum of £1,090 (the share of the profits to which the taxpayer would have been entitled) bore to the aggregate of £1,090 and the sum the taxpayer would have been entitled to recover from Mrs Pierce as damages for breach of the employment contract, if he had been paid his salary and a share of profits up to cancellation date and had then repudiated the contract.

Australian case law

38. The leading Australian cases on this issue are the High Court of Australia decisions in *McLaurin* and *Allsop*. The taxpayer in *McLaurin* had made claims for a total amount of £30,240 as compensation for damage to property as a result of a fire that had spread from a property owned by the Commissioner of Railways. Some of the claims were for amounts that were capital in nature and some for amounts that were revenue in nature. The Commissioner of Railways made a settlement offer of £12,350 and the taxpayer accepted it "in full settlement of all claims for damage arising out of" the fire.

39. The £12,350 lump sum offer was based on a valuation of the items of property for which the claims had been made, as carried out by a valuer employed by the Commissioner of Railways. There had been various discussions between the valuer and the taxpayer in the course of the valuer arriving at his valuation. However, the court found no information was given to the taxpayer as to how the amount was arrived at.

40. The Commissioner considered £11,000 of the compensation was income, being compensation for the revenue items claimed, determined on the basis of the valuation. The court accepted the valuation was based on a list of items supplied by the taxpayer and the taxpayer could make a confident guess as to the amount allowed by the valuer for each item claimed. However, the court considered the character of the payment in the hands of the recipient could not be determined by the payer's (the Commissioner of Railways) uncommunicated reasons for agreeing to pay the amount. The court considered the offer made and accepted was for a single undissected amount (not payments for each individual item claimed).

41. The court accepted that it may be appropriate to apportion a single payment of a mixed nature made in settlement of specific claims where at least some of the claims are for liquidated amounts or are amounts that are "otherwise ascertainable by calculation". In this context, the court referred to *Carter v Wadman* and *Wales v Tilley*. It gave *Carter v Wadman* as an example of a case that included liquidated claims and *Wales v Tilley* as an example of a case where some of the distinct claims were ascertainable by calculation.

42. However, the court considered apportionment was not appropriate where a payment is made only for claims for unliquidated damages under a compromise that treats the payment as a single undissected payment. In such circumstances, the amount must be considered as a whole. The court considered the damage caused by the fire (whether included in the taxpayer's claim or not) was

compensated for by one entire sum. There was no factual basis for the Commissioner's argument that the settlement payment was income on the basis it had the same character as the profits the taxpayer would otherwise have derived. The court, therefore, held the entire sum was capital in nature.

43. The court was concerned with establishing what the parties had agreed the amount was paid for. It was not relevant what one party had originally claimed was payable. It was also not relevant what the other party was willing to pay for (ie the uncommunicated reasons of the payer for making the payment were not relevant). Further, there was no discussion of the possibility of valuing the respective claims given up and apportioning on that basis. This may be because the parties had not argued the case on this basis.

44. *Allsop* concerned a taxpayer who was in the transport business. The taxpayer had paid the Commissioner for Motor Transport permit fees totalling £54,868 and had been allowed deductions for the permit fees. Following a decision by the Privy Council that the fees were not legally payable, the taxpayer sought recovery of the fees paid on the basis that the amounts had been improperly demanded under the colour of office. A settlement was negotiated under which the taxpayer was paid £37,500.

45. The settlement deed was made without any admission of liability on the part of the Government and the Commissioner for Motor Transport. The deed provided that, in consideration of the payment, the taxpayer released the Government and the Commissioner for Motor Transport from all actions, suits, proceedings, causes of action, arbitrations, debts, dues, demands, costs, charges and expenses the taxpayer had in connection with or arising out of anything done or omitted to be done under the relevant legislation.

46. The High Court of Australia rejected the Commissioner's argument that, as the payment was a refund of expenditure for which a deduction had been allowed, the amount was income. The court considered there was no factual basis for the Commissioner's argument.

47. Barwick CJ and Taylor J considered the taxpayer would have had valid claims against the Commissioner for unlawful interference with the taxpayer's vehicles and his business (even though no such claims had been made by the taxpayer). As the settlement deed provided the amount was paid for the release of all potential claims, Barwick CJ and Taylor J considered the entire payment was made by way of compromise of all claims the taxpayer had. No part of the payment was attributable solely to the refund of the fees paid.

48. Windeyer J held the consideration for the payment was the release of a variety of claims the taxpayer had or might be thought to have had against the Government. No part of the payment was received as a refund of permit fees paid by the taxpayer. In particular, Windeyer J appears to have been seeking evidence as to how the parties had calculated the amount before he would have been willing to apportion (at 65):

> It does not appear from the material before us that the sum of £37,000, or any definite part of it, was computed, paid and received as a refund of particular amounts that had been paid by the appellant for road charges and which had been allowed as deductions in the assessment of his taxable income.

49. The court did not consider attempting to value the respective claims given up. Rather the court seems to have been looking for evidence as to how the parties calculated the amount (ie what they agreed the amount was paid for). As the agreement contained (and, in that case, was limited to) a general release clause covering all potential claims, it was not possible to determine that any specific

amount was paid for any specific claim. The court, therefore, found the whole amount should be treated as capital.

50. *McLaurin* and *Allsop* have also been followed in later Australian decisions. In determining whether apportionment is possible, the courts have sought evidence of agreement between the parties as to how the amount was calculated. See, for example, *FCT v Spedley Securities Ltd* 88 ATC 4126 (FCA) at 4128:

> After negotiation, an entire sum of $200,000 was accepted. Its payment was the subject of agreement, **but there was no agreement as to the way in which it was made up**. The evidence as to the way the settlement was seen, from one side or another is scant. [Emphasis added]

51. The Court held that the entire amount was capital as the payment was received as a lump sum, the ingredients of which were not identified, so there was no basis for apportionment.

Conclusion on apportionment

52. In the Commissioner's view, the Australian and UK courts have taken different approaches to apportioning lump sum settlement payments. The courts in *Wales v Tilley* and *Carter v Wadman* were willing to accept apportionments based on objectively estimated values for different elements of the agreements. On the other hand, the High Court of Australia in *McLaurin* and *Allsop* seemed concerned with trying to find evidence of agreement between the parties as to how the lump sum was made up. In the absence of this, the courts found that no apportionment was possible.

53. Although *McLaurin* distinguished *Wales v Tilley* and *Carter v Wadman*, this, arguably, does not fully explain the different approaches to apportionment. The fact the agreement in *Carter v Wadman* included a liquidated amount did not appear to assist the court with determining any agreement between the parties. It was not a case where the court concluded an amount equal to the amount of the liquidated damages (in that case £1,090) was allocated to that head. In such a situation, it would be easier to argue that the parties had implicitly agreed on the amount to be allocated. However, the court found the £2,000 was paid as a lump sum to cover all of the rights given up. It found that £2,000 had to be apportioned according to the respective values of the different claims. In this regard, the fact there was an amount of liquidated damages was of no more assistance to the court than any other right that could be valued.

54. Similarly, the amounts making up the lump sum in *Wales v Tilley* do not seem to be any more easily "ascertainable by calculation" than the amounts in *McLaurin* or *Allsop*.

55. Neither *McLaurin* and *Allsop* nor *Wales v Tilley* and *Carter v Wadman* have been applied in New Zealand. The court in *Sayer* did suggest that, if the facts had been different, the taxpayer would have been able to argue that *McLaurin* and *Allsop* applied – however, this does not mean that such an argument would necessarily have been accepted. Rather, in the Commissioner's view, the broad approach taken in New Zealand apportionment cases is more consistent with the UK approach than the Australian one. It has been suggested that *McLaurin* and *Allsop* are authority for the proposition that, if an undissected settlement payment includes both capital and revenue amounts, the whole amount will be treated as capital. To the extent that *McLaurin* and *Allsop* stand for this proposition, the Commissioner's view is that they would not be followed in New Zealand. Rather, where possible, New Zealand courts would seek a reasonable basis for apportioning a lump sum.

56. It is noted that *McLaurin* and *Allsop* have also been judicially criticised by the High Court of Australia (see *FCT v CSR Ltd* No S278 of 2000, 23 November 2001). In that case, the Commissioner was seeking leave to appeal to the High Court. He argued that *McLaurin* and *Allsop* should be overturned despite their longevity. Ultimately, although critical of *McLaurin* and *Allsop*, the High Court denied the application for leave to appeal. This was because the cases had stood for (at that time) 40 years and Parliament had not chosen to overturn them by legislation. This was despite a recommendation by the Asprey Committee in 1975 that specific legislation be introduced to apportion on a valuation basis. As *McLaurin* and *Allsop* have never been applied in New Zealand, the High Court's reasons for not considering overturning *McLaurin* and *Allsop* are not relevant. However, their criticisms are equally valid in New Zealand as in Australia.

How should an appropriate apportionment be determined?

57. Any apportionment must be undertaken on an objective basis. The ultimate aim of apportionment is to determine what the amount was paid for and to split it into its capital and revenue parts. As well as considering any settlement agreement, it is likely to be necessary to look at the surrounding circumstances and other, related documentation.

58. Where it can be established that the parties to the settlement have agreed how the payment is made up, this will generally be an appropriate basis for determining the apportionment between capital and revenue amounts. However, the Commissioner may not accept such an apportionment where taking into account the relevant circumstances, the amount allocated to the capital element is excessive, the agreement is a sham, or the agreement is part of a tax avoidance arrangement (see *Case S96* at 7,606).

59. Often there will be no agreement between the parties as to how the lump sum was made up. The nature of settlement agreements is that they represent a compromise between parties with competing interests. For example, an employee may want a higher payment for hurt and humiliation, but their employer may prefer a higher payment for lost wages. Other times, the parties may care only about the total amount of the payment and may not have given any thought as to how it is made up.

60. Where there is no (or insufficient) evidence of how the parties intended the amount to be apportioned, it may be appropriate to calculate (or estimate) the value of the respective claims given up in return for the payment.

61. The terms of any statement of claim should be considered. How helpful a statement of claim is will depend on the particular circumstances. For example, a statement of claim is likely to be highly relevant where there is an express link to it in the settlement agreement (as in *Case V8*). At the other end of the spectrum, if the dispute was settled on a different basis to the statement of claim, it may be of little or no relevance in determining an appropriate apportionment (see *du Cros v Ryall* (1935) 19 TC 444 (KBD)). In situations in between, it is likely to be of some assistance along with evidence of later negotiations between the parties.

62. Evidence of negotiations between the parties prior to settlement and other background facts may also be relevant if they help determine what the payment was made for.

63. The relevance of a general clause releasing a party from all liability will be similarly fact dependent. In some circumstances, it will be included as an incidental element of a settlement agreement (as in *Case V8* and *Sayer*). In other cases, it may be intended to cover one or more claims (as in *Carter v*

Wadman). This will generally be a question of characterisation, rather than apportionment. As discussed above, it is essential to work out what the payment is for before considering apportionment. In *Allsop* the agreement consisted entirely of a general release clause. In the Commissioner's view, no apportionment would be required on the facts of *Allsop* as the full payment was made to settle a claim by the taxpayer of a revenue nature.

64. All relevant factors need to be considered when determining a reasonable basis for apportionment.

Amounts that cannot be apportioned

65. In the Commissioner's view, it will be possible to find an appropriate basis for apportionment in most situations. The taxpayer has the burden of proving that any apportionment is reasonable. Where a taxpayer does not make an apportionment, the Commissioner may, depending on the relevant facts and the information available, make an apportionment that the Commissioner considers is fair and reasonable.

66. There may be rare situations where no apportionment is possible. In these cases, the whole amount received should be treated the same. As noted above, for an amount to be taxable, it must be "income" under a provision in Part C. Where no part of the amount comes within a provision in Part C, none of the amount will be taxable.

67. However, where the lump sum includes an amount that is taxable under a provision in Part C, the taxpayer has the burden of proving what part of the amount is not taxable. If a taxpayer is unable to show what part of a lump sum payment is capital, the Commissioner's view is that generally the whole amount should be treated as income. This is consistent with *Buckley & Young* (at 61,283):

> If there is insufficient evidence to arrive at a conclusion, any answer must be mere speculation and the taxpayer will have failed to discharge the onus of proof upon him …

68. This is also consistent with the Commissioner's position as set out in the Commentary to BR Pub 05/12 *Taxability of payments under the Human Rights Act 1993 for humiliation, loss of dignity and injury to feelings*:

> Where the Commissioner has some doubt about the amount attributed to humiliation, loss of dignity, or injury to feelings, he may ask the parties to an agreement what steps they took to evaluate objectively what would be a reasonable amount to attribute to humiliation, loss of dignity, or injury to feelings. This would be so regardless of whether the payment was made as a result of an out of court settlement and whether or not the agreement is settled by the Human Rights Commissioner under the Human Rights Act. **The onus of proof regarding the taxability of any such payment would be on the taxpayer**. [Emphasis added]

References

Related rulings/statements

"BR Pub 05/12: Taxability of payments under the Human Rights Act 1993 for humiliation, loss of dignity, and injury to feelings" *Tax Information Bulletin* Vol 17, No 6 (August 2005): 4

"IS 16/04: Income tax – treatment of the receipt of lump sum settlement payments" *Tax Information Bulletin* Vol 28, No 12 (December 2016): 33

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Income Tax
Lump sum
Settlement payment

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