Inland Revenue
Te Tari Taake

TECHNICAL-DECISION SUMMARY > ADJUDICATION

WHAKARĀPOPOTO WHAKATAU HANGARAU> WHAKAWĀ

Whether settlement payments were taxable employment income

Decision date | Rā o te Whakatau: 30 June 2022

Issue date | Rā Tuku: 22 February 2023

TDS 23/01

Subjects | Kaupapa

Income tax: Settlement payment; whether employment income or payment for hurt and humiliation and therefore non-taxable; whether Record of Settlement is a sham.

Abbreviations | Whakapotonga

The abbreviations used in this document include:

CCS	Customer and Compliance Services, Inland Revenue
Commissioner	Commissioner of Inland Revenue
TCO	Tax Counsel Office, Inland Revenue

Taxation laws | Ture tāke

Section CE 1 and s CE 10 of the Income Tax Act 2007.

Facts | Meka

1. The dispute concerned the receipt by the Taxpayer from their former employer (**Employer**) of payments (**Settlement Payments**) under a settlement agreement between the Taxpayer and the Employer (**Record of Settlement**). The Employer withheld PAYE from the payments.
2. The Record of Settlement described the payments as salary and wages and that they were to be made over time, and the taxpayer's termination date was not until the payments ended.
3. The Taxpayer considered the Settlement Payments were in the nature of compensation for humiliation, loss of dignity, and injury to feelings under s 123(1)(c)(i) of the Employment Relations Act 2000 (**ERA 2000**) - referred to in this report as hurt and humiliation payments. The Taxpayer relied on the Commissioner's Public Ruling BR Pub 06/05 Assessability of Payments under the Employment Relations Act for Humiliation, Loss of Dignity, and Injury to Feelings (Inland Revenue, June 2006) (**BR Pub 06/05**) to argue the personal grievance document is the correct starting point for determining whether a payment is a hurt and humiliation payment.
4. Customer and Compliance Services, Inland Revenue (**CCS**) considered the payments were amounts derived in connection with employment or exit inducements and argued the Record of Settlement is the correct starting point for determining the true nature of the Settlement Payments.

5. The Taxpayer also argued the Settlement Payments could not have been ordinary salary or resignation payments because they had resigned before the payments were made. CCS argued the Taxpayer's termination date was as stated in the Record of Settlement.

6. The Taxpayer also argued the Record of Settlement was a sham to the extent it described the Settlement Payments as ordinary salary or resignation payments and is fraudulent and illegal. CCS disputed this.

Issues | Take

7. To establish whether the Settlement Payments were non-taxable capital receipts or taxable employment income for the Taxpayer, the following issues were considered:

   - Were the Settlement Payments in the nature of payment(s) for hurt and humiliation under s 123(1)(c)(i) of the ERA 2000?
   - Was the Record of Settlement a "sham" so far as it purports to describe amounts paid under s 123(1)(c)(i) of the ERA 2000 as regular salary and resignation payments, and in connection with this:
     - Was the Taxpayer nevertheless entitled to rely on sham because they were induced to enter into the Record of Settlement by duress, misrepresentation, or contractual mistake?
     - Was the Record of Settlement fraudulent (illegal)?
     - If the Taxpayer can assert sham (or if the Settlement Payments are in whole or in part in the nature of hurt and humiliation payments) has the Taxpayer proved the quantum of the Settlement Payments that can be apportioned to hurt and humiliation?

8. There was also a preliminary issue on the onus and standard of proof.

Decisions | Whakatau

9. TCO decided:

   - The Settlement Payments were not in the nature of payments for hurt and humiliation under s 123(1)(c)(i) of the ERA 2000.
   - The Record of Settlement was not a sham to the extent it describes the Settlement Payments as ordinary salary or resignation payments.

- If an authority or court found that the Record of Settlement is in part a sham, it is in any event considered that the Taxpayer could not assert sham on the basis that they are not bound by the Record of Settlement for reasons of duress, mistake, or misrepresentation.
- The Record of Settlement was not fraudulent (illegal).
- If an authority or court found that the Settlement Payments were in the nature of hurt and humiliation payments or the Record of Settlement was in part a sham, it is considered that a court or authority would seek to apportion the Settlement Payments having regard to the evidence available with the onus of proof resting with the Taxpayer to prove the quantum of any apportionment.

Reasons for decisions | Pūnga o ngā whakatau

Preliminary Issue | Take tōmua: Onus and standard of proof

10. The onus of proof in civil proceedings[1] is on the taxpayer, except for shortfall penalties for evasion or similar act, or obstruction.[2] The taxpayer must prove that an assessment is wrong, why it is wrong, and by how much it is wrong.[3]

11. The standard of proof in civil proceedings is the balance of probabilities.[4] This standard is met if it is proved that a matter is more probable than not. TCO applied a similar standard to considering the issues in this report, given the Taxpayer's ability to challenge any subsequent assessments that are made in civil proceedings.

Issue 1 | Take tuatahi: Nature of the Settlement Payments

12. The Taxpayer contended that:

- the main document for determining the nature of the Settlement Payments was the personal grievance, not the Record of Settlement. The nature of the payments was determined by considering whether the Taxpayer had a genuine

[1] Challenge proceedings (ie, the proceedings that would follow if this dispute proceeds to the Taxation Review Authority or a court) are civil proceedings.

[2] Section 149A(2) of the Tax Administration Act 1994 (TAA).

[3] *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 (CA); *Beckham v CIR* (2008) 23 NZTC 22,066 (CA).

[4] Section 149A(1) of the TAA; *Yew v CIR* (1984) 6 NZTC 61,710 (CA); *Birkdale Service Station Ltd v CIR* (1999) 19 NZTC 15,493 (HC); *Case X16* (2005) 22 NZTC 12,216; *Case Y3* (2007) 23 NZTC 13,028.

personal grievance for hurt and humiliation. This was consistent with IR's Public Ruling BR Pub 06/05,

- the evidence showed that the Taxpayer did have a genuine personal grievance against the Employer. As well as the personal grievance document and negotiations correspondence, the Taxpayer supplied medical evidence to support their claim, and
- based on the evidence, the Settlement Payments were genuine payments for hurt and humiliation under s 123(1)(c)(i) of the ERA 2000. It did not matter that they were not described as such in the Record of Settlement. The payments could not have genuinely been for the matters described in the Record of Settlement because the Taxpayer had resigned at the beginning of the period for which they were paid.

13. CCS argued that:

- the nature of the Settlement Payments was determined by looking at the relevant settlement agreement – in this case the Record of Settlement, and
- based on the Record of Settlement, the Settlement Payments were income from employment for the Taxpayer under ss CE 1 or CE 10 of the ITA 2007.

14. TCO considered the Commissioner's Public Ruling BR Pub 06/05 states that it applies to "payments that are genuinely and entirely for compensation for" hurt and humiliation. The parties did not dispute that BR Pub 06/05 correctly states how the tax laws apply to hurt and humiliation payments, i.e., they are capital (non-taxable) receipts. The Commentary on the Ruling states that hurt and humiliation payments stem from a personal grievance. There was originally a personal grievance in this case.

15. However, the Commentary on BR Pub 06/05 must be read in context. It is well established by case law that the tax consequences of transactions flow from the "true" (i.e., "genuine") legal nature of the arrangements the parties have entered into. This "true" legal nature is ascertained by analysing the contractual arrangements the parties actually entered into and carried out, rather than by reference to the broad economic substance of the arrangements.

16. Settlement agreements did not operate as variations to employment contracts. Instead, they replaced the legal rights and obligations the parties had with respect to one another under the relevant employment contract with new rights and obligations. The Record of Settlement therefore replaced the legal rights and obligations the Employer and Taxpayer previously had with respect to one another under the Taxpayer's employment contract with a new set of legal rights and

obligations. As such, the Record of Settlement was the correct starting point for determining the true (or genuine) nature of the Settlement Payments.

17. The case law provides that a contract (in this case the Record of Settlement) should be interpreted objectively, both by reference to its text and to any relevant extrinsic evidence (i.e., evidence outside the text of the contract). The relevant enquiry is what a reasonable and properly informed third party would consider the parties intended the words of their contract to mean[5].

18. An objective interpretation of the Record of Settlement leads to the conclusion that the Settlement Payments were not "payments that are genuinely and entirely for compensation for" hurt and humiliation, but instead were payments for employment services or an inducement for the Taxpayer to leave their employment. This was because the Taxpayer reached a negotiated settlement, and as part of that process, they agreed to give up their personal grievance hurt and humiliation claim in exchange for no admission of liability on the part of the Employer and no payment of compensation "for" hurt and humiliation. Although TCO did not doubt that the Taxpayer truly believed they had a genuine claim for hurt and humiliation, the Taxpayer chose to settle their claim rather than to prove it in the ERA or Employment Court. It was not open to the Taxpayer to prove their claim by providing further evidence of the personal grievance in this dispute.

19. In relation to the Taxpayer's argument that they had resigned and so could not have received income from employment, whether or not the parties described the arrangements they made as "garden leave" in the Record of Settlement or while negotiating, based on an objective interpretation of the Record of Settlement the Taxpayer was in fact on "garden leave" between reaching the settlement and their contractually agreed termination date. The "nomenclature used" (i.e., name given to the arrangement) by the parties was not decisive – what was important was that they were not required to attend work for a period before the legally agreed termination date.

20. To conclude, based on an objective analysis of the Record of Settlement, the "true" (or "genuine") legal nature of the Settlement Payments was as they were described in the Record of Settlement.

[5] *Investors Compensation Scheme Ltd v West Bromwich Building Society* [1998] 1 All ER 98 at 114 to 115. See also *Vector Gas Ltd v Bay of Plenty Energy Ltd* [2010] NZSC 5, and *Bathurst Resources Ltd v L&M Coal Holdings Ltd* [2021] NZSC 85

Issue 2 | Take tuarua: Whether there is a sham

21. CCS argued that the Record of Settlement was not a "sham" so far as it purported to describe amounts paid under s 123(1)(c)(i) of the ERA 2000 as regular salary and resignation payments because:

- An objective assessment of the Record of Settlement and surrounding evidence (the personal grievance, negotiation settlement correspondence and lawyer's notes) showed that the legal rights and obligations created by the parties were as they had been recorded in the Record of Settlement. Although the Taxpayer had requested a payment under s 123(1)(c)(i) of the ERA 2000, the Employer was on record as not being prepared to make such a payment. The Taxpayer had ultimately signed (and so accepted the written terms of) the Record of Settlement,
- The evidence provided by the Taxpayer did not prove that it was the subjective intention of the parties to create a document that did not reflect the true legal rights and obligations existing between the parties so as to deceive a third party. The statement made by the Employer (that the Employer is a Crown Entity and as such it must comply with the Crown Entities Act 2004 and guidance from the Auditor-General, and is subject to public scrutiny; and because of this the Employer was not prepared to make payments outside of its contractual parameters) should be taken at face value, and
- There was no evidence to suggest that the Taxpayer, as a party to the Record of Settlement, was deceived or induced to execute the Record of Settlement by fraud, mistake, misrepresentation, or duress. The Taxpayer had their own legal representation and a mediator was involved which provided further transparency to the process.

22. The Taxpayer argued that the Record of Settlement is a "sham" so far as it purported to describe amounts paid under s 123(1)(c)(i) of the ERA 2000 as regular salary and resignation payments because:

- An objective assessment of the Record of Settlement and surrounding evidence (the above, plus medical evidence) showed that the legal rights and obligations created by the parties were not as they were recorded in the Record of Settlement. The evidence showed the Taxpayer had a genuine personal grievance, and it is the personal grievance that is the true basis of any claim for a settlement payment. The Settlement Payments were due under s 123(1)(c)(i) whether or not the Employer accepted liability – it is irrelevant that the Employer stated it was not "prepared" to make payments under that section.

Further the Taxpayer had resigned from the Employer before the period for which the Settlement Payments were ostensibly made had commenced, and therefore the Settlement Payments were not even remotely connected with employment services provided to the Employer,

- The Employer (and lawyers) did have a subjective intention to deceive a third party - the Employer did not want to describe the payments as for hurt and humiliation because that would require disclosure of the payments to the Crown and the Auditor General. This was also why the Employer refused to describe any of the Settlement Payments as a contribution to the Taxpayer's legal and medical costs, and
- The Taxpayer was not a party to the "sham" because they were not present during the settlement negotiations (and nor was the mediator). Alternatively, (if the Taxpayer was a party to the "sham") the Taxpayer was pressured to sign the Employer's preferred form of document. No written evidence existed to this effect because it was self-evident that the Employer and lawyers would not create written evidence of this nature. There was no evidence to show the Taxpayer was well represented and the Taxpayer's lawyer did not in fact act in the Taxpayer's best interests. The mediator was involved only at the very end of the negotiations and their involvement did not add transparency to the process.

23. TCO reviewed case law and other material and concluded that the following points apply when considering whether a document is a sham:

- A sham is a document designed to lead third parties to view acts or documents as representing what the parties have agreed when the acts or documents do not show their true agreement.[6]
- For a document to be a sham, all of the parties to the document must have a common intention that the document is not to create the legal rights and obligations which it gives the appearance of creating.[7] There is no clear authority in New Zealand as to whether a party to a document who goes along with another's wishes has the required intention.

[6] *Snook v London & West Riding Investment Ltd* [1967] 1 All ER 518 (CA). See also *Ben Nevis Forestry Ventures Ltd & Ors v CIR* [2008] NZSC 115, (2009) 24 NZTC 23,188.

[7] *Bateman Television v Coleridge Finance* [1969] NZLR 794 (CA).

- A sham transaction may disguise either a real transaction or no transaction at all. Where real payments are made the alleged sham will (if proved) disguise a real transaction.[8]
- In determining whether a document is a sham a court is not restricted to examining the document and may examine extrinsic evidence. A party refuting an allegation of sham must produce credible evidence that the document is not a sham.[9] Evidence of the parties' subjective intentions and subsequent conduct may be examined.[10] Account may be taken of all of the surrounding circumstances and the documents may be looked at as a whole.
- Where the parties intend a document to take effect, and it does take effect according to its tenor, the transaction is not a sham.[11]
- A document may be "brushed aside" only if, and then only to the extent that, it is a sham. Part of a document may be a sham.[12]
- Sham is a serious allegation. Where a party alleges that a document is a sham, they must point to clear evidence that the document does not genuinely reflect the parties' intentions.[13] If they can do so, the evidentiary onus shifts temporarily to the other party to prove that the document does genuinely reflect the parties' intentions. However, in tax cases, the onus of proof remains with the taxpayer to show on the balance of probabilities that the Commissioner's assessment is wrong, and by how much it is wrong.

24. TCO considered that the Record of Settlement was not, in part, a sham. The Taxpayer asserted that the Employer's subjective intention was to make payments to them of compensation for hurt and humiliation but instead they entered into the Record of Settlement which stated the payments would be made as salary paid for discretionary leave and in lieu of notice, plus accrued holiday entitlements. It was considered, however, that the Employer's subjective intention was in fact to make the payments to the Taxpayer as salary and accrued holiday entitlements – i.e., exactly as they were recorded in the Record of Settlement. The Employer could not,

[8] *Richard Walter Pty Ltd v FCT* 96 ATC 4,550 (FCA).

[9] Abid

[10] *Clayton v Clayton* [2015] NZCA 30. The Supreme Court agreed with the Court of Appeal: see *Clayton v Clayton* (2016) 4 NZTR 26-002.

[11] *Paintin and Nottingham Ltd v Miller Gale and Winter* [1971] NZLR 164 (CA).

[12] *Re Securitibank Ltd (No 2)* [1978] 2 NZLR 136 (CA). See also *Glenharrow v CIR* (2005) 22 NZTC 19,319 (HC) and *Henwood v CIR* (1995) 17 NZTC 12,271 (CA).

[13] *Fraunschiel v FCT* (1989) 20 ATR 955 (FCA). See also *Ben Nevis Forestry Ventures Ltd & Ors v CIR* [2008] NZSC 115, (2009) 24 NZTC 23,188.

based on the State Services Commissioner's guidance, make the payments as anything else. The purpose of the State Services Commissioner's guidance was to prevent Crown Entities from entering into non-disclosure agreements (NDAs) that they could not comply with because of their obligations to report payments of compensation for hurt and humiliation to the Auditor-General (rather than to disguise the payments and deceive the Auditor-General, as the Taxpayer suggested).

25. If an authority or court found that the Record of Settlement was in part a sham, it was considered that the Taxpayer could not assert sham on the basis that they were not bound by the Record of Settlement for reasons of duress, mistake, or misrepresentation, for the following reasons:

- In terms of duress, although the Taxpayer was not present at the negotiations with the Employer and its lawyers, and was concerned about damage to their professional reputation, the Taxpayer was advised by lawyers and the settlement was a negotiated one. It did not appear that the Taxpayer's will was overborne by the Employer. Further, the Taxpayer did not bring an action (e.g., in the Employment Relations Authority or Employment Court) on the basis that they had signed the Record of Settlement under duress. A delay of about 30 weeks in bringing an action (by which time the employer had performed its part of the contract by making the settlement payments) was considered too long in a similar case.[14]
- In terms of contractual mistake, although relief is available under the Contract and Commercial Law Act 2017 (**CCLA 2017**) for a unilateral mistake that is known to the other party to the contract, or for a common or mutual mistake, relief is denied where the correct position becomes known to the party who is seeking relief before they enter into the contract (s 26 of the CCLA 2017) or where the relevant mistake is a mistake in interpreting the contract in respect of which relief is sought (s 25 of the CCLA 2017). If the Taxpayer was mistaken as to the Termination Date after the discussions between their lawyer and their Employer's lawyers, they became aware of their mistake prior to entering into the Record of Settlement. If they received and/or read the Record of Settlement, they made a mistake in interpreting the agreement in respect of which they would be seeking relief (i.e., the Record of Settlement). In terms of a mistake as to the tax treatment - there was no evidence that the Taxpayer considered the tax treatment of the Settlement Payments prior to entering into the Record of Settlement. A failure to consider a matter is not a "mistake" for

[14] *Sawyer v Vice Chancellor of Victoria University of Wellington* [2018] NZEmpC 71.

the purpose of the CCLA 2017, which requires a mistaken belief of fact or law to be held by a party prior to entering into a contract. If the Taxpayer did consider the tax treatment of the Settlement Payments prior to entering into the Record of Settlement, they would have become aware of their mistake prior to entering into the Record of Settlement (as the Settlement Payments were stated to be paid after deduction of tax) or otherwise made a mistake in interpreting the Record of Settlement (again, as the Settlement Payments were stated to be paid after deduction of tax). Therefore, relief for the mistake was excluded by s 26 or s 25 of the CCLA 2017.

- In terms of misrepresentation, a representation must induce a party to enter into a contract if relief is to be granted under the CCLA 2017. A representation will not induce a contract if a reasonable person would not take the meaning from it that was taken by the party to the contract; if the person making the representation did not, viewed reasonably, intend the party who seeks to rely on it to do so; or if the party seeking to rely on the representation becomes aware of its untruth before entering into the contract. Based on the facts of this dispute it was considered that the Taxpayer was not entitled to claim relief for misrepresentation (either by cancelling the contract or by way of damages) under Subpart 3 of the CCLA 2017. Even if the Taxpayer had been entitled to relief for misrepresentation under Subpart 3 of the CCLA 2017, s 149(1)(ab) of the ERA 2000 prevented the Taxpayer from cancelling the Record of Settlement under s 37 of the CCLA

26. The Record of Settlement was not fraudulent (illegal). The purpose of the State Services Commissioner's guidance was to prevent Crown Entities from entering into non-disclosure agreements that they could not comply with because of their obligations to report payments of compensation for hurt and humiliation to the Auditor-General (rather than to direct Crown Entities to disguise the payments and deceive the Auditor-General, as the Taxpayer suggested).

27. If an authority or court finds that the payments were in the nature of hurt and humiliation payments or the Record of Settlement was in part a sham, it was considered that a court or authority would seek to apportion the Settlement Payments having regard to the evidence available, including the Record of Settlement, evidence of the Taxpayer's entitlements under the Employer's CEA, the amount shown as requested by the Taxpayer in the pre-contractual negotiations correspondence, and the other extrinsic evidence. However, ultimately the onus of proof would rest with the Taxpayer to prove the quantum of any apportionment.