EMPLOYMENT DISPUTES: THE IMPLICATIONS OF TAXING OF SETTLEMENT RECEIPTS AS ELIGIBLE TERMINATION PAYMENTS

By Celeste M Black*

The recent application of the eligible termination payment provisions to amounts received on the settlement of employment-related disputes has lead to the result that such payments are taxed on the same basis as other employer-funded termination payments, such as golden handshakes. However, these settlement payments are fundamentally different in character to golden handshakes and arise from disputes which will often raise a number of issues, including claims which are personal in nature such as unfair dismissal or defamation. This article seeks to comprehensively analyse the various taxation regimes which may be triggered by such receipts and questions whether any coherent policy can be identified to support the level of taxation which these regimes provide.

1. INTRODUCTION

A number of decisions of the courts and Administrative Appeals Tribunal¹ have highlighted the taxation issues which can arise where a dispute relating to the termination of employment is settled or a court order is made requiring a payment by the employer to the employee. As a result of the connection between the payment and the termination, such a payment will be characterised for income tax

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purposes as an ‘eligible termination payment’ (‘an ETP’).\(^2\) In most circumstances, the ETP regime operates concessionally, allowing various components of a termination payment to be exempt from tax or subject to reduced rates. However, in the context of employment disputes, the ETP regime can effectively operate as a penalty by subjecting to tax amounts which would not be income under ordinary concepts and which would also be otherwise exempt from tax under the capital gains tax (‘the CGT’) regime.\(^3\) This can be the case, for example, where the termination payment includes compensation for wrongful dismissal, defamation or unlawful discrimination.\(^4\) This situation will be further exacerbated once the superannuation simplification tax changes previously announced by the Federal Treasurer in the 2006–07 budget take effect.\(^5\) It is submitted that these consequences are inappropriate and legislative amendment should be considered based on a fair and coherent policy for the taxation of these payments.

The taxation treatment of amounts received in relation to the termination of employment is dictated by the complex rules found in

\(^2\) The income tax is assessed by way of the coordinated application of the provisions of the *Income Tax Assessment Act 1936* (Cth) and the *Income Tax Assessment Act 1997* (Cth) (‘the ITAA 1997’). As part of a re-write process, many provisions of the former Act have been re-enacted in the latter Act using more accessible language and most often retaining the same meaning, though in some circumstances substantive amendments have also been incorporated. Throughout this article, reference will be made to both the section and relevant Act and year for the purposes of clarity. The term ETP is defined at *Income Tax Assessment Act 1936* (Cth) s 27A.\(^3\) The CGT provisions are found at divs 102 through 152 of the ITAA 1997.\(^4\) For example, in the decision of the Industrial Appeal Court of Western Australia in *Bennett v Higgins* (2005) 194 FLR 406, a payment in respect of unfair dismissal compensation was treated as an ETP.\(^5\) *Tax Laws Amendment (Simplified Superannuation) Act 2007* (Cth) sch 2 creates a new div 82 in the ITAA 1997 which applies to ‘employment termination payments’. These new measures were proposed in 2006 but only take effect in 2007. See Treasury, *2006/07 Budget Overview* (2006) 9–10; Treasury, *A Plan to Simplify and Streamline Superannuation* (2006).
subdivision AA of Division 2 of Part III of the *Income Tax Assessment Act 1936* (‘the ITAA 1936’). These rules grew out of a relatively simple provision, the former s 26(d), which has appeared in the income tax legislation in some form since 1915. Historically, s 26(d) was seen as a concession, whereby only 5 percent of a retiring allowance would be included in income whereas, under ordinary concepts, in many cases the entire payment would otherwise be assessable income as a reward for previous services. However, it was later acknowledged that s 26(d) could also operate to include in income 5 percent of amounts which would otherwise not be characterised as income. As a result, s 26(d) operated in both an exclusionary and inclusionary manner. Replacement of s 26(d) with the more complex ETP regime in 1983 saw the replacement of the 5 percent rule with a system which still includes most components of an ETP in income but then allows for rebates of tax which operate to put a ceiling on the rate of tax paid on the payment. The application of the ETP regime to settlement payments has thereby also subjected these payments to this rate scale, regardless of the underlying circumstances giving rise to the payment. What is not clear is whether this result was intended by the legislature. This article seeks to provide a background to the current provisions and consider some of the recent cases dealing with settlement payments. Emphasis is then given to cases which involve claims which are personal in nature, such as unlawful dismissal or defamation. It is submitted that these tax consequences must be fully appreciated by parties engaged

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6 Commonwealth Committee on Taxation, *Report on Assessability of Amounts Received in Relation to Employment and to Retirement from Employment* (1952) [10] (‘the Spooner Committee Report’).
7 Ibid [4]–[5]. This consequence was judicially recognised in *Reseck v Federal Commissioner of Taxation* (1975) 75 ATC 4213, 4215 (Gibbs J).
in settling these disputes and that there is a basis for a call for reform.⁹

Part II provides an overview of the treatment of termination payments under ordinary concepts and the impact of s 26(d) on this treatment. Part II also describes the current tax regime which applies to ETPs. Part III focuses on the development of the case law in relation to the application of the ETP provisions to settlement receipts. Part IV describes the potentially concurrent application of the CGT provisions to these settlement payments. Part V considers the exemptions available under the tax system for damages for personal injury and their availability in the case of an employment dispute. Part VI concludes.

2. OVERVIEW OF INCOME TAX PRINCIPLES

The assessable income of a taxpayer consists of ordinary income and statutory income.¹⁰ Ordinary income is defined as income according to ordinary concepts,¹¹ where the meaning of that term has been developed and elaborated upon through judicial decisions. Ordinary income includes, for example, rewards for services rendered (services income) and gains arising from carrying on a business (business income).¹² Statutory income is defined as amounts which are not ordinary income but are included in assessable income by operation of a provision of the ITAA.¹³ Various reconciliation rules operate to prevent the same amount of income from being included in assessable income more than once. The general

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¹⁰ ITAA 1997 s 6-1(1).
¹¹ ITAA 1997 s 6-5.
¹³ ITAA 1997 s 6-10(2).
reconciliation rule provides that, if the same amount is ordinary income and may be included in assessable income under a specific provision, the amount is only included once\(^\text{14}\) and the provisions of the ITAA prevail over the rules about ordinary income, thereby giving priority to the statutory income rules.\(^\text{15}\) Therefore, for example, a payment meeting the description of an ETP will be statutory income as ITAA 1936 s 27A operates to include it in income and the payment will not also be included in assessable income as ordinary income. This Part will commence with a discussion of the characterisation of termination payments under ordinary concepts of income and then move to an analysis of the statutory provisions which can also be triggered, with the focus being on the ETP regime. The purpose of this analysis is to highlight the practical effect of the application of the ETP legislation to settlement payments.

2.1 Termination Payments: Ordinary Income or Capital Receipts?

Whether a receipt in consequence of the termination of employment is considered income under ordinary concepts will depend in large part on the circumstances giving rise to the payment and may also depend on the form of the payment.\(^\text{16}\) Although a full

\(^{14}\) ITAA 1997 s 6-10(1).
\(^{15}\) ITAA 1997 s 6-25(2). Section 25 of the ITAA 1936 specifically did not include ETPs in assessable income. Rather, the specific provisions relevant to ETPs would determine whether an amount of an ETP was included in income (see subdiv AA of div 2 of pt III of the ITAA 1936).
\(^{16}\) Over time, the courts have developed rules regarding the meaning and scope of ‘ordinary income’. One approach which has been developed treats a receipt as ordinary income if it falls within one of five recognised categories of income. These five categories are as follows: income from services (personal exertion income); income from property; income from business; compensation receipts; and periodic receipts. This delineation can be seen in the principles of ordinary income set out in Parsons, above n 12, ch 2.
discussion of the concept of ordinary income is outside the scope of this article, the summary of authorities below is intended to highlight in what circumstances the application of the former s 26(d) (and therefore also the current ETP provisions) has either an exclusionary or an inclusionary effect.

Ordinary income includes income from services (also referred to as ‘personal exertion income’). A receipt will be considered income from services if it is a product, reward or ordinary incident of the provision of services. A retiring allowance, that is, a payment by an employer to an employee on normal retirement or proper dismissal, may be considered income under ordinary concepts on the basis that it is an additional reward for services provided. This is the case whether the payment is required under the terms of the employment contract or has been made voluntarily (an ‘ex gratia’ payment). Similarly, a payment of salary in arrears will be income even if in the form of a lump sum.

In contrast, where a contract for services has not expired and a payment is made to the employee to surrender rights under that contract, the receipt may be considered capital, not income, under ordinary concepts. This is based on the characterisation of the

17 This principle has been developed over time through judicial decisions. See, eg, Hayes v Federal Commissioner of Taxation (1956) 96 CLR 47; Scott v Federal Commissioner of Taxation (1966) 117 CLR 514. The principle has also been summarised by Parsons, above n 12, 123 as follows: ‘a gain which is a reward for services rendered or to be rendered has the character of income’.

18 It was considered that where an amount was made payable on termination pursuant to the employment contract and such payment was calculated based on the period of service, the payment was additional remuneration under the contract: Henry (Inspector of Taxes) v Foster (1931) 16 TC 605. In Dale (Inspector of Taxes) v de Soissons (1950) 32 TC 118, this principle was also applied to a payment due under an employment contract where calculation of the amount payable was based on the period remaining under the contract when it was terminated.

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services contract as a capital asset to the employee and therefore an amount received in compensation for release of those rights also has a capital character. In the case of Scott v Federal Commissioner of Taxation,\(^\text{20}\) the taxpayer’s position as a member of a board of directors was abolished and he was entitled to compensation based on the salary he would otherwise have been entitled to under the balance of the contract. In holding that the payment was not income, the analogy was made between an individual whose sole services contract is cancelled and a business which effectively is forced to cease cancellation of a principle contract.\(^\text{21}\) The payment was characterised as being in respect of prevention of the provision of future services and not compensation for past services.\(^\text{22}\) However, if the compensation were to take the form of a series of payments, there would be a risk that the payment would be characterised as a periodic receipt and would therefore be income as such.

In the case of Commissioner of Taxes (Victoria) v Phillips,\(^\text{23}\) the taxpayer had a service contract as governing director of a company and that contract was cancelled prior to its expiration. In compensation for the cancellation, Phillips received an amount equivalent to that to which he would have otherwise been entitled to under the contract, paid at intervals mirroring the term of the contract and for a term equivalent to the unexpired term of the contract. Due to this close correspondence, the court concluded that the payments should take their character from that which they replaced and were

\(^{20}\) (1935) 35 SR (NSW) 215 (‘Scott’).
\(^{21}\) Ibid 219 (Jordan CJ), referring to Californian Oil Products Ltd v Federal Commissioner of Taxation (1934) 52 CLR 28.
\(^{22}\) Scott (1935) 35 SR (NSW) 215, 221 (Jordan CJ). This distinction is highlighted by Parsons, above n 12, [2.388] citing as authority for capital characterisation the following: Chibbett v Joseph Robinson & Sons (1924) 9 TC 48; Carter v Wadman (Inspector of Taxes) (1946) 28 TC 41; Henley v Murray (1950) 31 TC 351; Comptroller General of Inland Revenue v Knight [1973] AC 428.
\(^{23}\) (1936) 55 CLR 144 (‘Phillips’).
therefore income.\textsuperscript{24} This decision should be contrasted with that in \textit{Bennett v Federal Commissioner of Taxation}.\textsuperscript{25} In that case, the taxpayer was appointed as managing director of a company for a period of seven years but less than one year into the contract, it was cancelled and replaced with a new contract with reduced terms. To compensate the taxpayer for the change in terms, he was granted a lump sum payable in instalments. The court concluded that the receipt was capital and distinguished it from the payments in \textit{Phillips}.\textsuperscript{26} In coming to its decision, the court noted that the payment did not relate to the services rendered by the taxpayer in the past and could also not be characterised as relating to services to be performed in the future.\textsuperscript{27} Rather, the payment was the price for surrendering a capital asset, being the valuable rights under the original contract.\textsuperscript{28}

Judicial authority also exists for the proposition that damages for wrongful dismissal are not income under ordinary concepts.\textsuperscript{29}

\begin{itemize}
\item \textsuperscript{24} Ibid 157 (Dixon and Evatt JJ).
\item \textsuperscript{25} (1947) 75 CLR 480.
\item \textsuperscript{26} Ibid 485 (Williams J).
\item \textsuperscript{27} Ibid 484 (Williams J).
\item \textsuperscript{28} Ibid 485. This principle was applied more recently in \textit{Federal Commissioner of Taxation v McArdle} (1988) 19 ATR 1901, where a payment received on surrendering the right to take up employee share options was not considered to be ordinary income as it was consideration for the surrender of valuable rights and not a sum received as a reward for services rendered. See also \textit{AAT Case 7752} (1992) 23 ATR 1057, where it was held that consideration for the surrender of the right to rostered days off was capital in nature and was only assessable by virtue of the application of ITAA 1936 s 26(e).
\item \textsuperscript{29} In \textit{Scott} (1935) 35 SR (NSW) 215, the sum payable to Mr Scott was based on what he would be entitled to had he been wrongfully dismissed. Although the court acknowledged that the measure of a payment does not necessarily determine its character, such a measure indicated that the amount should not be taxed as income unless a provision of the tax Act applied to make such a payment assessable: ibid 219–20 (Jordan CJ). See also R J Vann, ‘General Principles of the Taxation of Fringe Benefits’ (1983) 10(1) \textit{Sydney Law Review} 90, 113.
\end{itemize}
addition, a payment for entering into a restrictive covenant has also been found to not be income.\textsuperscript{30}

In general, a payment received on the settlement of a legal dispute or the issuance of a court order for damages arising from a termination dispute could contain many components, only some of which would be income under ordinary concepts. An amount which could be seen as additional compensation for services provided in the past, such as salary in arrears, would be ordinary income. However, it is likely that a significant part of such a payment will be compensation for early cancellation of the contract, wrongful dismissal or other related claims. These latter receipts would be considered capital in nature, not ordinary income, and would therefore be assessable only if a statutory provision applies to treat them as income. One such provision, the former s 26(d) (which evolved into the current ETP provisions), is considered next.

\textbf{2.2 A Brief History of Section 26(d)}

As mentioned previously, since the first federal income tax in 1915, there had been a principle of only taxing 5 percent of lump sums paid on retirement. Section 14(f) of the \textit{Income Tax Assessment Act 1915} (Cth) provided as follows:

> The income of any person shall include … (f) five per centum of the capital amount of a retiring allowance or gratuity, which is paid in a lump sum.\textsuperscript{31}

\textsuperscript{30} See \textit{Beak v Robson} [1943] AC 352; \textit{Higgs v Olivier} [1952] Ch 311. In Australia, the decision of the Full High Court in \textit{Hepples v Federal Commissioner of Taxation} (1992) 173 CLR 492 proceeded on the basis that the receipt for the restrictive covenant was not income and therefore was only assessable if found to be a taxable capital gain. In that case, the Court held that the receipt was not an assessable capital gain. The legislation has since been amended to ensure that such payments are now assessable under the CGT regime. See ITAA 1997 s 104-35.
This provision was re-enacted without change as s 16(f) of the *Income Tax Assessment Act 1922* (Cth). Several policy justifications have been given for this approach. According to the Spooner Committee, the legislature considered that it would be inequitable to tax the retiring employee in full on the amount as the sum was to be relied upon to live after retirement and, as a result, a somewhat arbitrary figure of 5 percent was selected as a reasonable proportion of the ordinary income tax. This approach looks forward, as it seeks to preserve the majority of the payment to support the employee in old age. In comparison, in its report, the Taxation Review Committee commented that the concession treatment was based on the fact that it would otherwise be inequitable to tax the whole sum on receipt when it may relate to employment which stretched over many years, thereby taking an approach which looks back. Either way, the provision is seen as operating as a concession, as the relevant payments would otherwise be taxable in full.

With the replacement of the federal income tax legislation in 1936, the concession for retiring allowances was significantly broadened. Section 26(d) of the ITAA 1936 stated as follows:

> The assessable income of a taxpayer shall include — … (d) five per centum of the capital amount of any allowance, gratuity or compensation where that amount is paid in a lump sum in consequence of retirement from, or the termination of, any office or

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31 It should be noted at the outset that the inclusion of the word ‘capital’ was not seen as adding anything to the application of the provision: the amount need not be of a capital nature, but it must be a lump sum. The Spooner Committee recommended that the word capital be eliminated from the provision: Spooner Committee, above n 6, [37]–[38]. This did in fact occur, but not until the reforms of 1983.  
32 Ibid [10].  
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employment, and whether so paid voluntarily, by agreement or by compulsion of law.

Several changes should be noted: the type of payment covered now also includes an amount of compensation; both retirement and termination are relevant causes for the payment; both employment and office are specified; and the payment may be voluntary (ex gratia), by agreement or by law. The explanatory memorandum to the Bill acknowledged the extension to compensation for termination of employment and stated that it was considered that consideration in those circumstances should be treated in the same manner as retiring allowances.\(^{34}\) It is this expanded version of the provision which has been the subject of extensive consideration by the Spooner and Asprey Committees.

Many of the issues addressed by the Spooner and Asprey Committees stem from the concession treatment afforded to payments which fell within the application of s 26(d) as compared to the treatment of pensions received on retirement and other payments of remuneration, which were assessable in full. This led to perceived abuses of s 26(d). For example, salary during the term of employment could be intentionally reduced and consequently a larger termination payment would be made.\(^{35}\) Another example given was a situation where a taxpayer could resign from one company within a corporate group and then be re-hired by another group company, where the termination payment from the first employer was eligible for assessment under s 26(d).\(^{36}\) There were no limits placed on the number of times a taxpayer could access the s 26(d) concession or on the aggregate amount so eligible.

\(^{34}\) Explanatory Memorandum, Income Tax Assessment Bill 1935 (Cth) 34.
\(^{35}\) Spooner Committee, above n 6, [8].
\(^{36}\) Asprey Committee, above n 33, [21.17].
The Spooner Committee recommended that there be a cap on the amount of retirement payments eligible for concessional taxation. They adopted a formula whereby the cap would be a multiple of the average monthly remuneration over the last five years, subject to an absolute cap of a fixed amount.\(^{37}\) Any amount received in excess of this amount would be assessable in full.\(^{38}\) However, the Spooner Committee recommended that a different treatment be afforded to amounts of compensation or damages paid as a result of termination (in contradistinction to retirement):

> It is considered that such payments, if voluntary and genuine, or if made as a result of court proceedings, are in the nature of commuted future remuneration and therefore a formula which permitted an amount varying directly with the length of the employee’s service would not be appropriate.\(^{39}\)

Instead, it was recommended that the cap not apply to such payments. However, where the facts show that a compensation payment is really a disguised retiring allowance, the Federal Commissioner of Taxation (‘the Commissioner’) should have the power to treat the payment as one subject to the cap, leaving the taxpayer to test the issue before the Commonwealth Taxation Board of Review.\(^{40}\)

In response to the recommendations of the Spooner Committee, there was an attempt to reform the regime in 1952 by putting an upper limit on the amount assessable under s 26(d). The measure was defeated on the basis that it would unjustly undermine the legitimate expectations of taxpayers that the amount of concessional retirement payments was uncapped.\(^{41}\)

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37 Spooner Committee, above n 6, [18].  
38 Ibid [20].  
39 Ibid [25].  
40 Ibid [26]–[27].  
41 Asprey Committee, above n 33, [21.22]–[21.23].
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In the mid-1970s, the Asprey Committee undertook a detailed evaluation of the tax system including the taxation of retirement benefits and put forward many proposals for reform.\textsuperscript{42} The Committee proposed that s 26(d) be repealed and replaced with a new regime which would put limits on the concessions available to lump sum payments. As stated in the report, ‘[i]f a person is entitled to a lump sum he should be quite free to receive it, but he should not gain an unwarranted tax advantage by doing so.’\textsuperscript{43} Although the specific recommendations of the Committee were not adopted, many of the features of the proposed arrangements were later enacted in the major reform of the taxation of retirement benefits which was announced in 1983. It is this regime which is with us today.

2.3 The Current Taxation of Eligible Termination Payments

It was not until 1983 that the treatment of retirement benefits was the subject of reform, but the reforms undertaken evidenced a fundamental shift in the taxation treatment of these payments. With the \textit{Income Tax Assessment Amendment Act (No 3) 1984} (Cth), s 26(d) was repealed and replaced with a new subdiv AA of Division 2 of Part III of the ITAA 1936. This new subdivision (‘the ETP provisions’) defined a new category of receipt, the ‘eligible termination payment’,\textsuperscript{44} and set out a detailed taxation regime for such payments. A detailed discussion of the taxation of ETPs is beyond the scope of this article but some of the more basic features are described below and put into the context of the discussion so far in this article. Broadly, the provisions include the ETP in the assessable income of the former employee but the payment is then subject to concessional rates of tax. In its 2007 budget papers, the

\begin{itemize}
\item \textsuperscript{42} Ibid ch 21.
\item \textsuperscript{43} Ibid [21.66].
\item \textsuperscript{44} ITAA 1936 s 27A.
\end{itemize}
The federal government has announced its intention to reform and simplify the taxation of superannuation. These proposals are also considered below in the context of settlement payments.

The term ‘eligible termination payment’ is broadly defined to mean ‘any payment made in respect of the taxpayer in consequence of the termination of any employment of the taxpayer’ and includes both employer payments and payments received from superannuation funds. In most circumstances, employer-funded payments will fall within para (a) of the definition and are therefore often referred to as ‘para (a) ETPs’. The concept of an ETP no longer refers to a ‘capital amount’ but the legacy of s 26(d) is obvious with the continued use of the requirement that the payment be ‘in consequence of termination of any employment’. The importance of the meaning of this phrase is analysed in detail below. The potential breadth of the definition also necessitated that certain payments be excluded back out of the ETP definition. The operation of some of these exclusions is considered in Part V.

To address the pre-reform expectations of taxpayers, the 5 percent concession is preserved through the operation of s 27C which includes in income only 5 percent of the ‘pre-July 83 component’ (which is that portion of the ETP which relates to services provided up to the introduction of the amending legislation, where this allocation is made based on days in the service period). The post-June 83 component is included in income by virtue of s 27B, but then a series of rebates may apply to limit the degree of taxation. The income tax rates which apply to this component of an ETP depend upon the age of the recipient and whether the payment is described as being ‘taxed’ or ‘untaxed’, where a ‘taxed’ payment is

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46 See the definition of ‘eligible termination payment’ at ITAA 1936 s 27A.
47 ITAA 1936 s 27AA.
generally sourced from a superannuation fund and an employer-funded payment will be ‘untaxed’. There are effectively three bands of tax rates which can be summarised as follows.

**Tax Rates Applicable to Employer-Funded (‘Untaxed’) ETPs*  

<table>
<thead>
<tr>
<th></th>
<th>Under Age 55</th>
<th>Over Age 55</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low Rate Part</td>
<td>Not applicable</td>
<td>Maximum of 15 percent</td>
</tr>
<tr>
<td>Remaining Part</td>
<td>Maximum of 30 percent</td>
<td>Maximum of 30 percent</td>
</tr>
<tr>
<td>Excessive Component</td>
<td>45 percent^</td>
<td>45 percent^</td>
</tr>
</tbody>
</table>

* In each case, the Medicare levy of 1.5 percent will also be payable

^ This rate being the current top marginal tax rate applicable to individuals

The rates for a ‘taxed’ payment take into account that contributions to a complying superannuation fund and the fund’s earnings are assessed at the rate of 15 percent. Therefore, the rate applicable to the total amount for recipients under the age of 55 is 20 percent and the rate applicable to the low rate part and the remaining part of an over age 55 ETP is reduced to 0 and 15 percent, respectively.

An ETP must first be measured against the taxpayer’s ‘reasonable benefit limit’ (‘RBL’) to determine if there is an amount in excess of this limit, which is called the ‘excessive component.’

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48 *Income Tax Rates Act 1986* (Cth) sch 7. This rate applies where taxable income exceeds $150 000 for the 2006–07 income year.
50 ITAA 1936 s 159SA.
The balance of the payment is then split into the ‘low rate’ and ‘remaining’ parts. The RBL effectively sets a lifetime limit to the amount of ETPs which are eligible for the concessional rates of tax, thereby putting into effect the recommendations of the Spooner and Asprey Committees. Initially, the RBL was individually determined as a multiple of the average salary of the employee (a recommendation of the Spooner Committee) but this mechanism was later abandoned in favour of an amount fixed by the legislation.\(^{51}\) If the employee is under the age of 55, the RBL is reduced by 2.5 percent for each year, thereby further limiting the concession. The ceiling for the low rate part was initially set at $50,000\(^{52}\) (also from the Asprey Committee report) and is indexed annually.\(^{53}\) The excessive component is included in assessable income and taxed at 45 percent if paid by an employer.\(^{54}\)

In the context of employment disputes, it can be seen that the ETP provisions do operate concessionally where the receipt on settlement would have otherwise been taxed as ordinary income, though the level of the concession has been reduced since the 1983 amendments. However, where the ETP includes components which would not otherwise be assessable, the ETP provisions operate to over-tax the receipt and this effect has been exaggerated since the repeal of s 26(d). However, to fully determine whether the components of the ETP would otherwise be assessable, one must not

\(^{51}\) ITAA 1936 s 140ZD. The lump sum RBL for the 2006–07 income year is $678,149. See Taxation Determination TD 2006/42. This amount is indexed annually.

\(^{52}\) ITAA 1936 s 159SF.

\(^{53}\) The limit of the low rate part for 2006–07 is $135,590. See Taxation Determination TD 2006/42.

\(^{54}\) Income Tax Rates Act 1986 (Cth) sch 7. Where a payment from a superannuation fund includes an excessive component, additional calculations must be undertaken to determine which part of the payment will be taxed at the lower rate of 38 percent and which will be subject to the 45 percent rate.
only consider the potential characterisation as ordinary income which was discussed above but also the possibility that the receipt would otherwise be subject to tax under the CGT regime. This is discussed in Part IV.

2.4 The Superannuation Simplification Amendments

As part of the 2006–07 budget, the Treasurer announced the intention of the government to significantly overhaul and simplify the taxation of superannuation. These amendments include substantial changes to the taxation of employer ETPs.\textsuperscript{55} A new type of payment category has been created for employer ETPs called the ‘employment termination payment’ which excludes ‘superannuation benefits’ but retains the requirement that the payment be made in consequence of termination.\textsuperscript{56} The pre-July 1983 component will be exempt from tax,\textsuperscript{57} leaving only the post-June 1983 component as taxable.\textsuperscript{58} Where the recipient is over the preservation age, a rate of 15 percent will apply to amounts up to $140,000.\textsuperscript{59} Any excess will be included in income and taxed at the top marginal rate.\textsuperscript{60} Where the recipient is under the preservation age, a rate of 30 percent will apply.

\begin{footnotes}
\item[55] These amendments were enacted as the Tax Laws Amendment (Superannuation Simplification) Act 2007 (Cth). The impact of the regime on employer ETPs was described in ch 7 of A Plan to Simplify and Streamline Superannuation, a document released by the federal government as part of the 2006–07 budget papers. After a period of consultation, the Treasurer released a paper outlining some additional measures and transitional arrangements. See Treasurer, ‘Simplified Superannuation: Final Decisions’ (Press Release, 5 September 2006); Treasurer, \textit{Simplified Superannuation: Final Decisions} (2006).
\item[56] ITAA 1997 new s 82-130.
\item[57] ITAA 1997 new s 82-140.
\item[58] ITAA 1997 new s 82-145.
\item[59] ITAA 1997 new s 82-10(3)(a). This cap of $140,000 is provided by s 82-160 and will be indexed.
\item[60] ITAA 1997 new s 82-10(2).
\end{footnotes}
to the first $140,000. ETPs will no longer be measured against RBLs so there will be no limit to the number of times that a taxpayer may take advantage of the low rate thresholds, except that payments will respect to the same termination will be assessed against the cap together. These payments will not be reportable to the Commissioner, and employer ETPs will no longer be capable of roll-over into a superannuation fund. A comparison of the rates of tax payable is shown below and illustrates that in fact employer ETPs will generally be subject to significantly higher rates of tax under the new regime.

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61 ITAA 1997 new s 82-10(3)(b).
TAXING SETTLEMENT RECEIPTS AS ETPs

Tax Rates Applicable to Employer-Funded (‘Untaxed’) ETPs

<table>
<thead>
<tr>
<th>Component</th>
<th>Under Age 55 (Current)</th>
<th>Under Preservation Age (New)</th>
<th>Over Age 55 (Current)</th>
<th>Over Preservation Age (New)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre-July 83 Component</td>
<td>5 percent included in income (individual marginal rate)</td>
<td>Exempt</td>
<td>5 percent included in income (individual marginal rate)</td>
<td>Exempt</td>
</tr>
<tr>
<td>Low Rate Part (Up to $135 590)</td>
<td>Not applicable</td>
<td>30 percent</td>
<td>Maximum of 15 percent</td>
<td>15 percent</td>
</tr>
<tr>
<td>(Proposed $140 000)</td>
<td></td>
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</tr>
<tr>
<td>Remaining Part</td>
<td>Maximum of 30 percent</td>
<td>Top marginal rate (45 percent)</td>
<td>Maximum of 30 percent</td>
<td>Top marginal rate (45 percent)</td>
</tr>
<tr>
<td>Excessive Component</td>
<td>Top marginal rate (45 percent)</td>
<td>Not applicable</td>
<td>Top marginal rate (45 percent)</td>
<td>Not applicable</td>
</tr>
</tbody>
</table>

The significant difference to be highlighted by the above table is that the top marginal rate will now apply to any amount of the ETP in excess of the $140 000 cap, as compared with the previous RBL threshold which is set at $678 149 for the 2006–07 income year.footnote{62}

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footnote{62} Taxation Determination TD 2006/42.
3. WHETHER THE SETTLEMENT PAYMENT IS ‘IN CONSEQUENCE OF TERMINATION OF EMPLOYMENT’

The discussion above highlights the importance of determining whether the sum received on settlement of the dispute is to be considered an ETP. The term ‘eligible termination payment’ is defined extensively for the purposes of the income tax and includes payments from various sources, including employers and superannuation funds.\footnote{ITAA 1936 s 27A.} With respect to payments from an employer, the usual characterisation of the payment as an ETP comes from meeting paragraph (a) of the definition which states that eligible termination payment means, amongst others, ‘any payment made in respect of the taxpayer in consequence of the termination of any employment of the taxpayer’.\footnote{Emphasis added.}

3.1 Interpretation of the Nexus Required

The meaning of the phrase ‘in consequence of the termination of any employment’ was first explicitly considered by the Full High Court in its decision in \textit{Reseck v Federal Commissioner of Taxation},\footnote{(1975) 133 CLR 45 (‘\textit{Reseck}‘).} where it was necessary to determine whether amounts received by the taxpayer were assessable as ordinary income or as retirement payments under the old s 26(d) which operated to only include 5 percent of the payment in assessable income.\footnote{This concession is still preserved in the current Act by virtue of ITAA 1936 s 27C, which includes in income only 5 percent of the retained amount of the pre-July 1983 component that part of the ETP which has been allocated to pre-July 1983 service.} The Court concluded that the amounts in question were paid in consequence of retirement but, in their opinions, Gibbs and Jacobs JJ adopted...
different interpretations of the meaning of the phrase. Gibbs J stated relevantly:

Within the ordinary meaning of the words, a sum is paid in consequence of the termination of employment when the payment follows on as an effect or result of the termination. … It is not in my opinion necessary that the termination of services should be the dominant cause of the payment.\(^{67}\)

Gibbs J noted that retiring allowances are often made in consequence of a number of circumstances in addition to the mere act of retirement, including prior satisfactory service and the provisions of an industrial award. In contrast, Jacobs J stated as follows:

It was submitted that the words ‘in consequence of’ import a concept that the termination of employment was the dominant cause of the payment. This cannot be so. A consequence in this context is not the same as a result. It does not import causation but rather a ‘following on’.\(^{68}\)

The comments of Gibbs J focused on causation while those of Jacobs J appeared to focus on a temporal progression. These differing interpretations gave rise to a number of cases where the courts struggled to apply the tests consistently.

The Full Federal Court in \textit{McIntosh v Federal Commissioner of Taxation}\(^{69}\) had an opportunity to consider the application of these two tests shortly following the decision in \textit{Reseck}. In each of the opinions of Brennan, Toohey and Lockhart JJ, it was considered that the comments of Jacobs J in \textit{Reseck} did not mean that the phrase merely required a temporal progression of events but did require

\(^{67}\) \textit{Reseck} (1975) 133 CLR 45, 51 (Gibbs J).
\(^{68}\) Ibid 56 (Jacobs J).
\(^{69}\) (1979) 10 ATR 13 (‘\textit{McIntosh}’).
some degree of connection. In *McIntosh*, the taxpayer retired from employment and thereby became entitled to certain benefits from the relevant provident (retirement) fund. Under the fund rules, each member had the option to commute part of his or her pension benefit into a lump sum. McIntosh made such an election and received his lump sum within one month of the retirement date. As a result, the direct cause of the payment of the lump sum was McIntosh’s exercise of his right to commute the pension, not his retirement. However, the view of each member of the Court was that such a payment was nonetheless in consequence of retirement as the relevant connection between the entitlement and the retirement could be found.

3.2 Application to Employment Disputes

The issue that confronted the court in *McIntosh* lay virtually undisturbed until the relatively recent Federal Court decision in *Paklan Pty Ltd (in liq) v Federal Commissioner of Taxation* (1983) 14 ATR 457. The taxpayers in the *Paklan* case had received payments from their former employer (which had ceased business) as well as from a directors’ fund and a staff fund. With respect to the payments from the employer, Northrop and Fisher JJ, in their majority opinion, concluded that under the circumstances (including the fact that nearly 12 months had passed between the cessation of employment and the payments), the occasion to which the payments were linked was not the termination of employment but rather the availability of funds for distribution arising from the sale of the business: ibid 476. As a result, the payments were not assessable income under s 26(d) (where only 5 percent would be assessed) but were assessable under s 26(e) (and therefore fully assessed). The payments from the funds were considered capital sums to which the members had become entitled upon the company ceasing business: ibid 477–8.

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70 See the decision of Brennan J to the effect that the nexus must be at a minimum a ‘but for’ connection: ibid 16. Toohey J considered that ‘following on’ meant that retirement was a prerequisite for the payment: ibid 19. Lockhart J held that a connection which was causal in character must be found in addition to a temporal progression of events: ibid 25.

71 The Full Federal Court came to a similar formulation of the nexus test in *Paklan* v *Federal Commissioner of Taxation* (1983) 14 ATR 457. The taxpayers in the *Paklan* case had received payments from their former employer (which had ceased business) as well as from a directors’ fund and a staff fund. With respect to the payments from the employer, Northrop and Fisher JJ, in their majority opinion, concluded that under the circumstances (including the fact that nearly 12 months had passed between the cessation of employment and the payments), the occasion to which the payments were linked was not the termination of employment but rather the availability of funds for distribution arising from the sale of the business: ibid 476. As a result, the payments were not assessable income under s 26(d) (where only 5 percent would be assessed) but were assessable under s 26(e) (and therefore fully assessed). The payments from the funds were considered capital sums to which the members had become entitled upon the company ceasing business: ibid 477–8.
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*Le Grand v Federal Commissioner of Taxation*. In that case, the taxpayer had made a claim for wrongful termination with damages comprising base remuneration, profit share, and compensation for distress, humiliation and loss of reputation. An offer of compromise was made by the former employer and accepted by Le Grand, resulting in a lump sum payment. The taxpayer argued that the payment was not an ETP as it was not made in consequence of termination of employment but rather in consequence of settlement of litigation. The characterisation of the payment as an ETP was particularly critical in this case as, in addition to the income tax, the termination payments tax (which has since been repealed) also applied to the payment. After considering the authority of *Reseck* and *McIntosh*, Goldberg J stated as follows:

The thrust of the judgments in *Reseck* and *McIntosh* is rather to the effect that a payment is made ‘in consequence’ of a particular circumstance when the payment follows on from, and is an effect or result, in a causal sense, of that circumstance. … [I]t can be said that a payment may be made in consequence of a number of circumstances and that, for present purposes, it is not necessary that the termination of employment be the dominant cause of the payment so long as the payment follows, in the causal sense referred to in those judgments, as an effect or result of the termination. … I am satisfied that the payment was an effect or result of that

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72 (2002) 51 ATR 139 (‘*Le Grand’’).
73 This tax was imposed under the *Termination Payments Tax Imposition Act 1997* (Cth) and assessed under the *Termination Payments Tax (Assessment and Collection) Act 1997* (Cth). A rate of 15 percent phased in and was fully applied where the adjusted taxable income of the taxpayer reached the surcharge threshold, which was $99 710 for 2004–05. This surcharge was particularly harsh up until 2001, when the extra 15 percent tax applied to the whole of the ETP (including any excessive component) resulting in an effective tax rate on the excessive component of 63.5 percent. It was this consequence which sparked the tax litigation in *Le Grand*. The surcharged proved to be very unpopular and was repealed effective from the 2005–06 year of income by the *Superannuation Laws Amendment (Abolition of Surcharge) Act 2005* (Cth).
termination in the sense that there was a sequence of events following the termination of the employment which has a relationship and connection which ultimately led to the payment.\textsuperscript{74}

The Court then also determined that the entirety of the payment, including the excessive component, was made in consequence of termination and therefore was subject to the termination payments tax.

Shortly after the decision in \textit{Le Grand}, the Commissioner issued \textit{Taxation Ruling TR 2003/13} which considered the meaning of the phrase ‘in consequence of’ in the context of ETPs. It was considered that the ‘narrower view’ of the meaning of the phrase (one requiring a causal connection in the sense that the payment follows as an effect or result) was to be preferred.\textsuperscript{75} With respect to payments to settle a claim for wrongful dismissal or claims of a similar nature, it was considered clear from the decision in \textit{Le Grand} and the Federal Court decision in \textit{Dibb}\textsuperscript{76} that such payments will have the sufficient causal connection with termination to be ETPs: such payments would not have been made but for the termination.\textsuperscript{77}

More recently, the Full Federal Court considered the settlement of proceedings in \textit{Dibb v Federal Commissioner of Taxation}.\textsuperscript{78} The employment of the taxpayer was terminated in 1996 but Dibb protested on the basis that it was unlawful, harsh, unjust and unreasonable. He brought proceedings initially before the Queensland Industrial Relations Commission and later in the Federal Court. The claims were many and included the following: conspiring to terminate the employment contract without proper cause or warning with the purpose of injuring the applicant; breach of

\textsuperscript{74} \textit{Le Grand} (2002) 51 ATR 139, 148 (Goldberg J).
\textsuperscript{75} \textit{Taxation Ruling TR 2003/13} [5], [29].
\textsuperscript{76} \textit{Dibb v Federal Commissioner of Taxation} (2003) 53 ATR 290.
\textsuperscript{77} \textit{Taxation Ruling TR 2003/13} [31].
\textsuperscript{78} (2004) 55 ATR 786 (‘\textit{Dibb}’).
TAXING SETTLEMENT RECEIPTS AS ETPs

fiduciary duty of trust and confidence; breach of the Trade Practices Act 1974 (Cth); and personal injury, loss and damage as a direct and natural flow from the employer’s actions.79 The Court determined that the payment on settlement of the action was properly characterised as an ETP:

The various causes of action, whether breach of contract, conspiracy, breach of fiduciary duty or contravention of the Trade Practices Act 1974 (Cth) were, as Goldberg J would say (Le Grand (at [36])), ‘interwoven and intertwined’ with the termination. The payment was a consequence of the termination. … Although much happened between Mr Dibb’s dismissal and the settlement of the Federal Court Proceedings, those events and the passage of time all arose out of his complaints concerning his dismissal. Neither those events nor the passage of time altered the fact that the payment of the lump sum settlement was ‘in consequence of the termination’. 80

This decision confirms the position adopted by the Commissioner in the public ruling.

3.3 The Relevance of Intervening Circumstances

The Commissioner has taken an arguably contrary view with respect to the required degree of nexus between termination and a lump sum payment in several cases where an entitlement to regular compensation payments (due to injury) has been commuted to a lump sum.81 In each case, the taxpayer had suffered an injury which lead to a cessation of employment. The taxpayer was then entitled to regular (usually weekly) compensation payments under the relevant

79 Ibid 790 (Spender, Dowsett and Allsop JJ).
80 Ibid 795.
compensation Act. As a result of additional circumstances, the taxpayer then becomes entitled to redeem the weekly payments and receive a lump sum. The view taken by the Commissioner in these instances was that the lump sum took its character from the pension it replaced and was therefore income according to ordinary concepts. The payment was not in consequence of termination of employment but as a consequence of the operation of the compensation regulations and therefore was not an ETP. A characterisation of the payment in each case as an ETP would have benefited the taxpayer as the payment would be subject to a lower level of tax or could even be considered partially exempt as an invalidity payment under s 27G.

In the decision of the Federal Court in Federal Commissioner of Taxation v Pitcher,\(^82\) Ryan J considered the issue and concluded that such a payment would be considered to be an ETP. The taxpayer in that case was a member of the Australian Army, serving with the military police. He suffered an injury which rendered him medically unfit for service. He was then discharged and began to receive weekly compensation payments. After receiving retraining, Mr Pitcher was able to return to employment such that his future entitlements to compensation payments were reduced to a low level. The reduction of the taxpayer’s weekly payments to below a certain level triggered the operation of s 30(1) of the Safety, Rehabilitation and Compensation Act 1988 (Cth), which thereby required the Military Compensation and Rehabilitation Service to pay him a lump sum redemption amount. The Commissioner contended that the redemption payment was made in consequence of the operation of s 30(1) and not as a result or effect of the termination of employment and, therefore, the payment was not an ETP.\(^83\) The Court disagreed, Ryan J holding as follows:

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\(^82\) (2005) 60 ATR 424 (‘Pitcher’).

\(^83\) Ibid 432.
In my opinion, however, the termination of employment was a necessary prerequisite for, and cause of, the respondent’s entitlement to the redemption payment under s 30 of the SRC Act. … Comcare’s liability to make payments under s 20 arose, in part, because the respondent was compulsorily retired from his employment in the army.

I consider that the tribunal was correct to find that the weekly payments of compensation to the respondent were the result of a sequence of events that followed the termination of the respondent’s employment and that they were connected with the lump sum paid by way of redemption. … It follows that the tribunal made no error in determining that the amount of $34,439.29 was made in consequence of termination of employment and constituted an ETP.84

Although the Commissioner would technically consider this a loss, the approach taken by Ryan J is, in fact, consistent with the Commissioner’s submissions in the dispute settlement cases. In the dispute-related cases, the Commissioner has taken the view that intervening acts, such as the lodging of a court action and subsequent negotiations, do not sever the nexus between the termination of employment and the compensation receipt. Similarly, in these redemption cases, as the entitlement to the payment can be linked back to termination, the payment will retain its character even though a number of years may have passed and additional steps must be taken which result in the payment.

84 Ibid 437 (Ryan J).
4. THE APPLICATION OF THE CAPITAL GAINS TAX REGIME

4.1 The Right to Seek Compensation

The settlement of an employment dispute may also raise CGT consequences which must be fully explored. To determine what, if any, CGT consequences arise from the settlement of an employment dispute, one must first identify the relevant ‘CGT asset’ and a relevant ‘CGT event’ which will then lead to a determination of an amount of capital gain or loss. The broad definition of ‘CGT asset’ includes intangible rights (both legal and equitable) and it is accepted that the right to seek compensation is a CGT asset.

Where a right to seek compensation is released, extinguished or otherwise ceases to exist by way of a court order or a deed of release, there is a CGT event C2 with respect to the right. The treatment of the compensation receipt for CGT purposes will depend upon whether the receipt is treated as solely related to the right to seek compensation, or if a ‘look-through’ approach is adopted whereby one identifies the relevant underlying asset to which the receipt relates. Where the relevant asset is considered to be the right to sue, the capital proceeds received on ‘disposal’ of the right are compared

85 ITAA 1997 s 108-5.
86 See, eg, Tuite v Exelby (1993) 25 ATR 81 (breach of restrictive covenant); Carborundum Realty Pty Ltd v RAIA Archicentre Pty Ltd (1993) 25 ATR 192 (suit for negligence); Provan v HCL Real Estate Ltd (1992) 24 ATR 238 (breach of contractual and fiduciary duties). This view has been adopted by the Commissioner. See Taxation Ruling TR 95/35.
87 CGT event C2, ITAA 1997 s 104-25. For a detailed discussion of the CGT consequences of a disposal of a right of action, see B Zimmermann, ‘Capital Gains Tax: Taxing the ‘Right to Seek Compensation’ (2004) 19 Australian Tax Forum 159. See also Hines, above n 9, 236.
with any amounts forming its ‘cost base’\(^{88}\) to determine the amount of capital gain or loss.

Where, in the case of a right to seek compensation, an underlying asset can be identified, the Commissioner takes the view that the compensation receipt will be considered received in relation to that underlying asset rather than the right to seek compensation.\(^{89}\) In this way, any exemptions that relate to the underlying asset will also apply to the compensation receipt. This treatment can be illustrated by the following two examples.

An issue which has been raised before the courts and the Commissioner is the treatment of a deposit taken on the sale of real property which is later forfeited. A specific CGT event applies if the sale of the property does not proceed.\(^{90}\) However, if the forfeiture occurs ‘within a continuum of events’ which ultimately results in the disposal of the property, the Commissioner takes the view that the forfeited deposit is to be included in the capital proceeds obtained from the sale.\(^{91}\) If the property is the main residence of the taxpayer, those proceeds (including the forfeited deposit) will fall under the main residence exemption.\(^{92}\) In this way, the Commissioner is willing to look through the right to the deposit and consider the character of the underlying asset, being the main residence which has (ultimately) been disposed of by the taxpayer.

By way of an additional example, the Commissioner has issued a class ruling which addresses the treatment of compensation receipts

\(^{88}\) ITAA 1997 s 110-25.

\(^{89}\) Taxation Ruling TR 95/35 [70].

\(^{90}\) CGT event H1, ITAA 1997 s 104-150. This view as to the application of ITAA 1997 s 104-150 and its predecessor, ITAA 1936 s 160ZZC(12), has been confirmed by the decision of the Full Federal Court in 


\(^{91}\) Taxation Ruling TR 1999/19 and addendum.

\(^{92}\) ITAA 1997 s 118-110.
under the Indigenous Wages and Savings Reparations Process. In the ruling, it is considered that the recipient has an intangible CGT asset, being the right to sue in respect of alleged loss, injustice or racially discriminatory impact suffered as a result of the Protection Acts. Such rights would be discharged or satisfied by virtue of acceptance of payment under the Reparations Process. This could be treated as a CGT event C2 in relation to the right to seek compensation. However, the view taken by the Commissioner is that the personal injury exemption found at ITAA 1997 s 118-37 will apply to the receipts since the underlying wrong has been suffered personally by the recipient. The nature of this personal injury exemption will be considered in detail below.

4.2 Application to Termination Payments

In the case of an employment dispute where its resolution includes the termination of the employment relationship and the making of a compensation payment, two assets may be identified. The first asset is the right to seek compensation for the alleged wrongs suffered, which may be numerous and include claims for loss:

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93 Class Ruling CR 2003/35.
94 The same approach has also been taken in Class Ruling CR 2002/59 with respect to compensation payments to Holocaust survivors under the Remembrance, Responsibility and Future Foundation set up by the German Parliament. The C2 event is acknowledged but the personal injury exemption is then considered to be available. Similarly, if the compensation is in relation to damage to property, as the underlying property would have pre-CGT status, the compensation payment is also disregarded for CGT purposes. Under the Commissioner’s view, where the receipts were paid to the heirs (but not ‘relatives’ as defined) of the persons suffering personal loss or to heirs or relatives of persons suffering property damage, such payments would not have benefited from the look-through approach and would be assessable as receipts for the discharge of the right to compensation under the Foundation law. However, this result has been specifically overridden by legislative amendment. See ITAA 1997 s 118-37(4), inserted by Taxation Laws Amendment Act (No 1) 2003 (Cth), and the addendum to Class Ruling CR 2002/59.
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of income, unfair dismissal, anxiety and depression, and defamation of character. The right to pursue each claim may itself be an asset or the totality of the claims may be treated as one composite asset where the claims are dealt with as one. In this context, the exemption for wrongs or injury sustained by a taxpayer personally or in respect of his or her occupation may be relevant.\footnote{ITAA 1997 s 118-37(1)(a), (1)(b).} In addition, the employment contract which underlies the action may also be a relevant CGT asset under the look-through approach.

If the look-through approach is applied, the settlement amount will be treated as the capital proceeds for relinquishing the employment contract (a C2 event). These proceeds would be then compared to the cost base (if any) which the taxpayer has in the contract. The excess of capital proceeds over cost base is the amount of capital gain. The capital gain can then be reduced by any amount which is included in the assessable income of the taxpayer by virtue of a provision outside the CGT regime.\footnote{ITAA 1997 s 118-20.} This reduction provision would be triggered where the receipt can also be characterised and included in income as an ETP, as discussed below. For the purposes of this reduction, if any part of an ETP is included in income, the whole of the payment is taken to be included.\footnote{ITAA 1997 s 118-22 (inserted by Tax Law Improvement Act (No 1) 1998 (Cth)).} So, for example, if only 5 percent of a concessional component is included in income, this provision would have the effect of treating the entirety of the ETP as included in income so that the capital gain would be reduced by the total amount of the ETP, thereby preserving the concession.

If a balance still remains after the application of these provisions, a general reduction of 50 percent of the gain is available to an individual where the asset has been owned for at least 12 months.\footnote{ITAA 1997 ss 115-10, 115-25. The capital gain may also be reduced by any realised or carry forward capital losses.}
A right to seek compensation is considered to be acquired on the happening of the event giving rise to the right. Therefore, if settlement occurs more than 12 months after the event, the discount should be available. The net capital gain is then included in the assessable income of the taxpayer and subject to the taxpayer’s marginal tax rate. The net gain on settlement of the action may therefore effectively be subject to a tax rate of up to 24 percent.

If the look-through approach is not adopted, the receipt will be considered to be derived by virtue of the discharge or release of the right to seek compensation, also a CGT event C2. Under these circumstances, a taxpayer could then rely on the s 118-37 exemption to disregard gains made on all claims which relate to personal injury or injury in relation to one’s occupation. The application of this broad exemption is discussed in Part V below, but this would likely cover many claims made. However, this exemption does not relieve any potential taxation under the ETP provisions.

5. PERSONAL INJURY EXEMPTIONS

Employment disputes often raise the issue of damages for injuries which are personal in nature. Within the income tax regime, various exemptions are provided for compensation for injury. However, these exemptions have not been drafted uniformly and it is submitted that their application in an employment-related context can

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99 Taxation Ruling TR 95/35 [86]. Pursuant to the acquisition rules found at ITAA 1997 s 109-5, if an entity (here the employer) creates a right (the right of action) in you (the employee), the employee acquires the asset when the right is created, which is when the actions, such as the termination, were taken by the employer. This assumes that these same circumstances amounted to a D1 event (ITAA 1997 s 104-35) to the employer. See Zimmerman, above n 87, 165, 169. Although technically any proceeds received on creating the right should be compared with the incidental costs incurred, there would not be any proceeds at this point and the market value substitution rule of ITAA 1997 s 116-30 does not apply to D1 events.

100 This amount is 50 percent of 45 percent (the top marginal income tax rate) plus the 1.5 percent Medicare levy.
TAXING SETTLEMENT RECEIPTS AS ETPs

lead to inconsistent or even absurd results. Consideration of relevant background documents, such as the explanatory memoranda which accompanied the introduction of the provisions, does little to alleviate this position.\textsuperscript{101}

This Part of the article considers the following three personal injury exemptions: the CGT exemption under ITAA 1997 s 118-37; the ETP exemption under paragraph (n) to the ETP definition; and the FBT exemption under paragraph (m) of the definition of a ‘fringe benefit’ in s 136 of the \textit{Fringe Benefits Tax Assessment Act 1986} (Cth). It is submitted that these various provisions operate inconsistently when applied to real life scenarios and offer no clear government policy on the treatment of such receipts. An additional ETP exemption exists for so-called ‘invalidity payments’ received under circumstances where, as a result of a disability, the taxpayer is unable ever to be employed in a capacity for which the taxpayer is reasonably qualified.\textsuperscript{102} Such payments are less likely to be made as a

\textsuperscript{101} Under the \textit{Acts Interpretation Act 1901} (Cth) s 15AA, in interpreting a provision, a construction which promotes the object or purpose of the Act is to be preferred. In this regard, reference to extrinsic materials may be of assistance: \textit{Acts Interpretation Act 1901} (Cth) s 15AB.

\textsuperscript{102} The exemption from income for an invalidity payment is made by ITAA 1936 s 27CB, which also states that such a payment is not taken into account for CGT purposes. An invalidity payment, as defined in ITAA 1936 s 27G, is an ETP made to the taxpayer where the termination occurs because of a disability where two medical practitioners have certified that the disability is likely to result in the taxpayer being unable ever to be employed in a capacity for which the taxpayer is reasonably qualified because of education, training or experience. The amount of the invalidity payment is that portion of the ETP which relates to the period from the actual termination date until the last retirement date, effectively exempting that part of the payment which relates to the period in which the taxpayer can no longer continue to work. For payments made before 1 July 1994, the requirement was that the payment was made by reason of the person’s physical or mental incapacity to engage in that employment and there was no requirement for medical certificates. However, the tax treatment of such payments also differed in that the pre-1 July 1994 invalidity
result of a termination dispute and therefore are not addressed specifically in this article.

It should be noted that the personal injury exceptions were all added to the taxation legislation in the mid-1980s and, to a greater or lesser degree, serve to preserve the exemption of such amounts from income taxation. The issue of the treatment of compensation for personal injury was addressed specifically in the Full Report of the Asprey Committee in 1975. As a starting point, it was noted that ‘[c]ompensation in a lump sum for personal injury is not included in income.’ 103 Except for the element of the compensation which represents lost income, any compensation for loss of earning capacity, pain and suffering and reduced life expectancy was not considered to be of an income character. 104 After discussing the judicial calculation of compensation awards on the application of the Gourley principle, 105 the Committee concluded that there should be no change to the exclusion of personal injury compensation from income:

The continuing exclusion from income of compensation for physical injury must rest primarily on the importance of the element of non-economic loss reflected in the compensation. Whatever the theory of the comprehensive tax base may suggest, it would be a significant departure from accepted ideas to include in income amounts received which are in respect of physical suffering and disability as distinct

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103 Asprey Committee, above n 33, [7.34].
104 Ibid.
105 In Cullen v Trappell (1980) 146 CLR 1, the High Court took the view that Australia should follow the position adopted by the House of Lords in British Transport Commission v Gourley [1956] AC 185, whereby income tax consequences should be taken into account in determining the amount of damages awarded. For a more detailed discussion of the development of these doctrines, see P Burgess, ‘Income Taxation of “Personal” Damages’ (2002) 31 Australian Tax Review 79.
from being for the reduced capacity of a person to earn which may attend that suffering and disability.\textsuperscript{106}

And later on the subject of injury to reputation:

In the Committee’s view there is no ground for distinguishing such compensation [for injury to reputation] from compensation for injury to the person, and it proposes that it too be excluded from income.\textsuperscript{107}

In \textit{Taxation Ruling IT 2424}, the Commissioner acknowledged the general law approach to the treatment of compensation payments, that is, that compensation for loss of income would be in the nature of income while, on the other hand, compensation for personal injury, injury to feelings, humiliation, embarrassment, depression, anxiety, etc is not liable to income tax but is a payment of a capital nature.\textsuperscript{108} Such capital payments would not be subject to tax under the CGT regime due to the exemption described below.\textsuperscript{109}

\section*{5.1 The Capital Gains Tax Exemption}

The introduction of the CGT regime was foreshadowed in the \textit{Draft White Paper}\textsuperscript{110} released by the federal government in June 1985 and then formally announced by the then Treasurer Paul Keating in September 1985.\textsuperscript{111} The original personal injury CGT exemption was provided under ITAA 1936 s 160ZB(1), which stated as follows:

A capital gain shall not be taken to have accrued to a taxpayer by reason of the taxpayer having obtained a sum by way of

\begin{thebibliography}{9}
\bibitem{106} Asprey Committee, above n 33, [7.37].
\bibitem{107} Ibid [7.41].
\bibitem{108} \textit{Taxation Ruling IT 2424} [8].
\bibitem{109} Ibid.
\end{thebibliography}
compensation or damages for any wrong or injury suffered by the taxpayer to his or her person or in his or her profession or vocation.

It is considered that this provision has its origins in a similar exemption then found in the Capital Gains Tax Act 1979 (UK).\textsuperscript{112} The explanatory memorandum which accompanied the relevant Bill states that ‘within this category are damages for personal injuries or for libel, slander or defamation, and insurance monies under personal accident policies.’\textsuperscript{113}

When the CGT provisions were re-drafted, s 160ZB(1) was replaced with ITAA 1997 s 118-37 which uses somewhat different language to describe the exemption.\textsuperscript{114} That section now provides as follows:

A capital gain or capital loss you make from a CGT event relating directly to any of these is disregarded:

(a) compensation or damages you receive for any wrong or injury you suffer in your occupation;

(b) compensation or damages you receive for any wrong, injury or illness you or your relative suffers personally.

The first obvious change in the coverage of the exemption is the extension to ‘illness’, which did not appear in the original exemption. A second extension is that to damages for any wrong suffered by a

\textsuperscript{112} The Capital Gains Tax Act 1979 (UK) provided as follows at s 19(5): ‘It is hereby declared that sums obtained by way of compensation or damages for any wrongs or injury suffered by an individual in his person or in his profession or vocation are not chargeable gains.’ See M W Inglis, Inglis on Capital Gains Tax (1990) 144–6.

\textsuperscript{113} Explanatory Memorandum, Income Tax Assessment Amendment (Capital Gains) Bill 1986 (Cth) 56.

\textsuperscript{114} This exemption was originally found at ITAA 1997 s 118-15 (inserted by Tax Law Improvement Act (No 1) 1998 (Cth)), but was later moved to ITAA 1997 s 118-37 (without any change relevant for current purposes) by the Taxation Laws Amendment Act (No 4) 1999 (Cth).
relative. Neither the explanatory memorandum nor the second reading speech to the relevant Bill provide any explanation for these changes.

The provision evidences the continued intention of Parliament, since the original version of this provision was introduced in 1985, to preserve an exemption from tax for compensation for personal and occupational injuries. In its discussion of the provision, the Commissioner concludes that this exemption is to be read widely and this view is supported by the explanatory memorandum to the original legislation. In fact, the Commissioner goes as far as to say that the exemption should be ‘read as widely as possible’ and would include claims for discrimination, harassment and victimisation as well as wrongful dismissal and illness.

5.2 The Eligible Termination Payment Exemption

As discussed above, the treatment of retiring allowances was the subject of significant reform in 1984, when the previous s 26(d) was replaced by the ETP regime. The ETP provisions have, since introduction, provided a personal injury exemption by excluding from the meaning of the term ‘eligible termination payment’ as found in s 27A the following:

(n) consideration of a capital nature for, or in respect of, personal injury to the taxpayer, to the extent to which the amount or value of the consideration is, in the opinion of the Commissioner, reasonable having regard to the nature of the personal injury and its likely effect on the capacity of the taxpayer to derive income from personal exertion.

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115 Taxation Ruling TR 95/35 [213].
116 Ibid [214].
117 Ibid [220].
118 These amendments were introduced by way of the Income Tax Assessment Amendment Bill (No 3) 1984 (Cth).
This exemption has remained without amendment since its introduction and has merely been re-written for the purposes of the superannuation simplification reforms.\textsuperscript{119} There are few comments made in the explanatory memorandum which accompanied the original Bill. However, on close examination of its terms, it is clear that the exemption as drafted is quite narrow. To access the exemption, the following elements must be shown:

- the receipt must be of a capital nature;
- the receipt must be for or in respect of personal injury;
- the amount must be reasonable in the opinion of the Commissioner; and
- a link must be established between the quantum of payment and the impact of the injury on income earning capacity.

In the general discussion of the main features of the Bill which introduced the ETP regime, it was stated in the explanatory memorandum that the new taxation treatment under the ETP provisions was to apply to three classes of payments: retirement and kindred payments which are generally assessable under s 26(d) as to 5 percent; certain amounts which are not taxed at all under s 26(d) (eg commutations of pensions and payments from superannuation funds); and payments from approved deposit funds.\textsuperscript{120} It was then stated that the changes would not apply to, amongst others, capital sums paid as compensation for ‘loss of income through personal injury’; these payments were to remain subject to the existing law.\textsuperscript{121} What is not specifically addressed is the intention of Parliament with respect to compensation in relation to personal injury which does not

\textsuperscript{119} The new exemption can be found at ITAA 1997 s 82-135(i).
\textsuperscript{120} Explanatory Memorandum, Income Tax Assessment Amendment Bill (No 3) 1984 (Cth) 4.
\textsuperscript{121} Ibid 5.
fit within the strict terms of the exemption. For example, an award of damages may relate to a personal injury but may compensate for medical expenses incurred or pain and suffering rather than loss of income. By way of further example, a receipt may not be intended to be for loss of income but, rather, may be compensation for injury to reputation, damages for injuries arising from discrimination where the injuries are personal in nature but not physical, or damages paid for wrongful dismissal. Such receipts are clearly not included in the three categories listed in the explanatory memorandum as the target of the reforms. Without further comment, it is difficult to determine that the intent of the Parliament with respect to such compensation receipts was to subject them to tax in the same manner as other employer-funded payments, such as golden handshake payments.

Another issue which has been given little consideration is the role of the Commissioner’s discretion in determining the amount of the payment which qualifies for the exemption. Where a court order has been issued which specifically allocates a portion of the award as in relation to loss of income resulting from personal injury, the case should be a simple one of the Commissioner accepting that allocation. However, in perhaps the majority of these cases, the amount will either be unallocated or arise from a settlement in which the defendant admits no liability. In a draft taxation ruling (which has since been withdrawn), the Commissioner took the view that, in order to claim this exemption, a taxpayer must seek an opinion of the Commissioner either by way of private ruling or by including the amount in assessable income in the return for the year and then objecting to the tax assessment. The taxpayer would be required to supply to the Commissioner supporting documentation such as medical reports and legal opinions, any statement of claim, and the employment contract or industrial award, on which the

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122 Draft Taxation Ruling TR 1999/D1 [8]. This ruling was withdrawn on 8 May 2002 on the basis that a ruling on this issue was now considered unnecessary.
Commissioner could then make a judgment. When this element of the test was recently considered in *Re McCunn and Federal Commissioner of Taxation*, the Administrative Appeals Tribunal concluded that the taxpayer was unable to succeed as she did not establish that injuries were in fact sustained and did not establish the link between the payment and the purported injuries. In the deed of release, it was noted that the taxpayer intended to bring various claims against her employer, some of which could have included personal injury claims, but as the dispute was settled, the taxpayer was not required to show evidence to support those claims. One may well query whether it is appropriate to then require a party in such a case to supply this evidence to the Commissioner, and whether he or his agents have the appropriate expertise to make findings as to injury.

5.3 The Fringe Benefits Tax Exemption

Also as a result of the recommendations made in the Draft White Paper, in 1985 the government announced that a comprehensive regime for the taxation of fringe benefits would be introduced. The *Fringe Benefits Tax Act 1986* (Cth) imposes the fringe benefits tax upon the fringe benefits taxable value of employers during the relevant year. Critical to this determination is the definition of the term ‘fringe benefit’ which can be found at s 136 of the *Fringe Benefits Tax Assessment Act 1986* (Cth). The fringe benefits tax (‘the FBT’) is relevant in the context of terminations since it applies to benefits provided by ‘employers’ to ‘employees’ where both of these

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123 (2006) 62 ATR 1216, 1229 (‘McCunn’).
124 The claims listed were the following: discrimination or harassment (or both); victimisation; breach of contract; misrepresentation; assault; and negligence. Ibid 1218.
125 Commonwealth, above n 110, ch 8.
126 Keating, above n 111, attachment B, ch 2.
127 *Fringe Benefits Tax Act 1986* (Cth) s 5 (‘FBTAA’).
terms are defined to include former employers and former employees.\textsuperscript{128} As a result, the mere fact that a payment is made after the termination of employment will not preclude the application of FBT.

The definition of ‘fringe benefit’ includes two important exclusions. Paragraph (k) prevents the FBT from applying to ETPs. Paragraph (m) excludes ‘consideration of a capital nature for, or in respect of: … (ii) personal injury to a person.’ Unfortunately, the explanatory memorandum to the original FBT Bill does not provide any comment on the policy underlying this exclusion.\textsuperscript{129} In a termination case, as shown above, the payment will in most cases be an ETP and therefore will be excluded from the FBT regime by paragraph (k). If, however, part of the payment is excluded from being an ETP due to the personal injury exclusion, paragraph (m) would then operate to also exclude that element from the operation of the FBT.

5.4 Interaction of the Provisions

Before moving to the analysis of these provisions by the courts, the interaction of these three exemptions should be understood. As previously discussed, the settlement of an action or the handing down of a court order will amount to a CGT event since the right to sue for damages is a CGT asset and the conclusion of the matter will amount to a release or satisfaction of that right (the event). Whether the event has taxation consequences depends upon the application of any CGT exemptions or reductions.

In the ordinary case, assuming that the termination of employment has a causal relationship to the action, the receipt will

\textsuperscript{128} FBTAA s 136.
\textsuperscript{129} The exemption is merely noted in Explanatory Memorandum, Fringe Benefits Tax Assessment Bill 1986 (Cth) 133.
meet the threshold tests to be an ETP. If some or all of the ETP is included in income, such as an ordinary employer ETP or in the case of a post-1994 invalidity payment (which only provides for part of the payment to be exempt), the capital gain will be reduced to nil as the whole of the amount is treated as included in income.\(^{130}\) As the payment is an ETP, it will not also be a fringe benefit due to the paragraph (k) exclusion. As a result, the payment will only be taxed under the ETP regime.

Where a personal injury is involved, the results will differ. If the payment is excluded from the definition of an ETP because it meets the requirements of the personal injury exclusion (para (n)), it will not be included in assessable income so the CGT reduction provision is not triggered. Rather, it is in this circumstance that the exemption found at s 118-37 will apply to also exempt the receipt from CGT. For the purposes of the FBT regime, paragraph (m) of the definition of ‘fringe benefit’ should also operate to exclude the amount from FBT. Therefore, the exemption is preserved through all three mechanisms of the income tax regime.

However, it is apparent that there is no consistent policy for exempting personal injury compensation if one compares the position of an employee recipient to that of a non-employee. One could easily envisage circumstances where two individuals have brought an action for defamation, where the action in one case is brought against a former employer following termination and in the other case the defendant is a third party. If each claimant were to settle the action and receive a payment, the first individual would be obliged to pay income tax under the ETP regime up to marginal rates. On the other hand, as the CGT exemption in s 118-37 is much broader than the ETP exemption, the second individual’s receipt will

\(^{130}\) ITAA 1997 ss 118-20, 118-22.
be tax exempt. This is a clear violation of equity principles and is unlikely to be an intended result of the operation of the provisions.

5.5 The Meaning of ‘Personal Injury’

It would be noted from the discussion above that the meaning of ‘personal injury’ is critical to the application of the ETP exemption. Recent consideration of this issue by the courts suggests that personal injury can include disease or illness but may not extend to injuries which, though personal, are not of a physical nature (ie damages to reputation). These cases are discussed below.

The Full High Court considered the meaning of personal injury and the causal link between the injury and the payment for the purposes of the para (n) exclusion in *Federal Commissioner of Taxation v Scully.*

Under the facts of the case, the taxpayer–employee was involved in a car accident which left her permanently disabled and unable to undertake paid work. A claim of total and permanent disablement was lodged with her superannuation fund and duly paid. The Commissioner treated the amount as an ETP and an invalidity payment, including 5 percent of the payment in assessable income as it was a pre-July 1994 payment. The taxpayer argued that the whole of the payment should be exempt under para (n). The issue before the Court was whether the payment was ‘consideration … for, or in respect of, personal injury’ and therefore within para (n).

The majority of the High Court held that the payment was not ‘consideration … for, or in respect of, personal injury’ and allowed the Commissioner’s appeal. The critical fact for the Court was that the calculation of the benefit paid made ‘no attempt to place a monetary value on the member’s injury’ and therefore could not be seen to be compensation for the particular injury; a connection with

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131 (2000) 201 CLR 148 (‘Scully’).
132 Ibid 168 (Gaudron ACJ, McHugh, Gummow and Callinan JJ).
the personal injury was not enough. In coming to its decision, the
majority also commented on the meaning of ‘personal injury’:

We see no reason to think that ‘personal injury’ in para (n) excludes
disease, illness or infirmity. … Nor does there seem to us any reason
in principle or policy why ‘personal injury’ should be so limited. If
the injury is such that it can ground an action in negligence or under
workers’ compensation legislation, there is no reason for thinking
that it is outside the ambit of para (n). It is beyond doubt that many
diseases contracted in the course of employment or otherwise may
properly be the subject of such an action.\(^133\)

Based on these comments, where part of a settlement or
judgment is compensation for this broader meaning of injury (ie one
which includes disease, illness or infirmity), such a payment would
be exempt from tax by virtue of para (n) of the ETP definition as
well as s 118-37, provided of course that the other requirements of
the exemption are met, ie the reasonableness of the amount based on
the impact on earning capacity.

The application of the para (n) exemption was also considered in
the Administrative Appeals Tribunal case \(\textit{Re McMahon and Federal}
\textit{Commissioner of Taxation}\).\(^134\) After a dispute arising from
termination of employment, the taxpayer received two payments.
The first was for loss of remuneration which was characterised as an
ETP. The other payment was for damage to reputation and the
taxpayer argued that this payment should be exempt under para (n).
The Tribunal rejected the taxpayer’s argument:

\[\text{T}\]he section is intended to exclude from the definition of ETP
payments in respect of injuries to the person, where such injuries
being [sic] physical injuries or mental illnesses which have an
assessable and identifiable impact on the capacity of the taxpayer to

\(^{133}\) Ibid 167.
\(^{134}\) (1999) 41 ATR 1056 (‘McMahon’).
earn income. The tribunal considers in summary that an injury to a person is distinguishable from an injury to a person’s reputation.\footnote{\textit{Ibid} 1069 (Senior Member Block).}

In coming to this decision, the Tribunal also cited with approval the case of \textit{Graham v Robinson}.\footnote{[1992] 1 VR 279.} The issue in that case involved the application of the jurisdictional limits of the Magistrates’ Court, where a claim for personal injury was subject to a ceiling of $5000 whilst ‘any other case’ had a claim ceiling of $20 000. At issue was whether a claim for damages for defamation was a claim for damages in respect of a personal injury and therefore subject to the lower ceiling. Smith J concluded as follows:

In the absence of express authority, I have come to the conclusion that the expression ‘personal injury’ does not extend beyond physical injury and mental illness to include emotional hurt. \ldots It is true that damages are awarded for pain and suffering in the typical personal injury case. They are awarded, however, where pain and suffering flow from and are connected with physical or mental injury and may therefore be said to be damages ‘in respect of personal injury’. \ldots In a defamation action, the injury is to reputation, not physical or mental health, and the emotional hurt that flows from that. A claim for damages in such a case may be said to be ‘in respect’ of injury to reputation, not injury to the person.\footnote{\textit{Ibid} 281 (Smith J).}

In both \textit{McMahon} and \textit{Graham v Robinson}, a distinction was drawn between mental illness, which would be considered personal injury, and harm which merely has an emotional or psychological impact. This latter type of harm would not fit in the para (n) exclusion but would only qualify for the CGT exemption. This distinction was supported in the Full Federal Court’s later decision in

\footnotesize
\begin{itemize}
\item \textit{Ibid} 1069 (Senior Member Block).
\item [1992] 1 VR 279.
\item \textit{Ibid} 281 (Smith J).
\end{itemize}
Dibb,\textsuperscript{138} which was discussed earlier in the context of the nexus requirement for ETPs.

In the *Dibb* case, the taxpayer had made various claims, all of which were settled under a deed of release. Included in the claims were damages for physical and mental injury and damage to employment reputation. The claims were supported by medical certificates evidencing a diagnosis of and treatment for anxiety and depression as well as dermatitis, hypertension and a gastrointestinal disorder, all said to be caused by the dismissal and the surrounding circumstances. The Court considered whether Mr Dibb was entitled to the para (n) exclusion for some part of the settlement payment:

‘Personal injury’ encompasses injury or disease of a physical or psychological nature. However, it would not extend to anguish, distress or embarrassment of the kind traditionally taken into account in assessing damages for defamation [citing *Scully* and *Graham v Robinson*]. … [S]ome of the complaints of damage the applicant raised in the Federal Court proceeding consisted of anxiety and depression and thus ‘personal injury’.\textsuperscript{139}

However, the Court was unable to grant the exemption for part of the payment as it concluded that it was impossible for the Commissioner to identify the relevant amount paid as consideration for the injury. In the absence of a court finding, the reasoning of the Court seems to suggest that the parties would need to have agreed that the taxpayer had suffered a personal injury before the exemption would be available.\textsuperscript{140} It is submitted that such an agreement is highly unlikely in the case of a deed of settlement and requiring such an agreement would be an unreasonable restriction on the availability of the exemption. The issue of apportionment is discussed more fully below.

\textsuperscript{138} *Dibb* (2004) 55 ATR 786.
\textsuperscript{139} Ibid 802–3 (Spender, Dowsett and Allsop JJ).
\textsuperscript{140} Ibid 803.
Also of interest are the published views of the Commissioner on the meaning of ‘personal injury’ and the availability of the exemptions. As discussed earlier in this article, the Commissioner takes the view that the CGT exemption is to be read as broadly as possible to cover ‘the full range of employment and professional type claims’, including damages for discrimination, harassment and victimisation.\textsuperscript{141} What is less clear is the view of the Commissioner on the application of the ETP exemption in similar circumstances, though it would appear from, in particular, more recent issued statements that the Commissioner takes a revenue maximising approach in the application of the ETP provisions and limits the availability of that exemption.

In earlier statements by the Commissioner, there is some indication of a view that personal injury compensation payments would generally be exempt from taxation. In an early ruling on compensation for unlawful discrimination, various situations were identified, such as sexual harassment in the workplace, where a general statement was made that such payments would not be liable to tax.\textsuperscript{142} Only in the case of unlawful dismissal was there an acknowledgement that the compensation payment would be an ETP.\textsuperscript{143} What is interesting about this ruling is the lack of acknowledgement that in many cases of unlawful discrimination the employment relationship will have in fact ceased and therefore, under the broad interpretation of the nexus test for the purposes of the ETP provisions, these payments will not in fact be excluded from taxation. This could indicate a view that the Commissioner would

\textsuperscript{141} Taxation Ruling \textit{TR} 95/35 [214].
\textsuperscript{142} Taxation Ruling \textit{IT} 2424. See, eg, paragraph 12 in relation to sexual discrimination in hiring practices, paragraph 14 in relation to sexual harassment in the workplace, paragraph 18 in relation to discrimination in the terms or conditions of employment and paragraph 21 in relation to impairment to prospects for employment.
\textsuperscript{143} Ibid [24].
not seek to apply the ETP provisions except in instances where the damages arose from unlawful dismissal, therefore requiring a direct nexus with the termination.\textsuperscript{144}

However, it is clear from a draft ruling issued in 1999 that the Commissioner was at this time taking a very narrow view of the paragraph (n) ETP exemption. In \textit{Draft Taxation Ruling TR 1999/D1}, the Commissioner takes the view that

the term ‘personal injury’ refers to an injury suffered to the person as opposed to the person’s property, character or reputation. It covers physical injury (internal and/or external) and/or mental injury that is clearly discernible to a qualified medical practitioner.\textsuperscript{145}

In describing the injuries covered by the exemption, the draft ruling draws a distinction between three types of injuries: a behavioural injury (physical or mental injuries); a non-behavioural injury, which would include defamation and wrongful dismissal; and property injury. Only the first type is considered personal injury within the exemption.\textsuperscript{146} By way of example, aggravation of a psychiatric

\begin{footnotesize}
\item[144] See also \textit{Taxation Determination TD 92/130}. The ruling was entitled ‘Income tax: capital gains: does subsection 160ZB(1) exclude from the operation of Part IIA compensation or damages obtained by a taxpayer for defamation, the loss of support following the (wrongful) death of the taxpayer’s spouse or parent or the professional negligence of a solicitor failing to institute a personal injuries action?’ In coming to the conclusion that all such payments were exempt it was stated that ‘[a] wrong or injury suffered by a taxpayer to his or her person includes a situation where a taxpayer is defamed’: ibid 3. In a notice of withdrawal issued on 9 June 1999, the explanation for withdrawal of the ruling was that ITAA 1997 s 118-15 extends the exemption to amounts received by a spouse or a relative and does not evidence a change of opinion as to the treatment of these receipts.
\item[145] \textit{Draft Taxation Ruling TR 1999/D1} [4]. This draft ruling was released on 20 January 1999 but was withdrawn on 8 May 2002. The notice of withdrawal states that the Commissioner considered the ruling unnecessary since the ruling was issued with the expectation that another ruling would rely heavily on the meaning of personal injury, but the second ruling was now not to be issued.
\item[146] Ibid [11]–[12].
\end{footnotesize}
illness would be personal injury.\textsuperscript{147} Although this draft ruling was withdrawn (rather than finalised) in 2002 and the distinction between behavioural and non-behavioural injuries has not been restated, the narrow view taken by the Commissioner of the availability of the ETP exemption continues and can been seen in several interpretive decisions\textsuperscript{148} and in the arguments made in recent cases such as \textit{McMahon} and \textit{McCunn}.

\textbf{5.6 The Problem of Apportionment}

As was noted in the discussion above, the para (n) exclusion from the ETP definition is available where an amount is paid as consideration for or in respect of personal injury, which includes both physical and psychological injury or disease. In the case of an ETP which is intended to satisfy multiple claims, it is therefore necessary for the payment to be apportioned between the various claims before the exemption will be available for the relevant component. In the \textit{Dibb} case, the court agreed with the Commissioner that there was no way of dissecting the settlement payment in that case and therefore no way to identify any part of the sum as consideration for personal injury.\textsuperscript{149} In fact, as will often be

\textsuperscript{147} Ibid [36].

\textsuperscript{148} For example, in \textit{Commissioner ID 2001/767}, a stressful work environment lead an employee to seek medical treatment for physical symptoms but this was not considered a case of personal injury. In \textit{Commissioner ID 2002/322}, where circumstances surrounding termination resulted in claims for damage to reputation, credibility and future employment prospects (and physical symptoms), the receipt, although exempt from CGT, was still assessable as an ETP. Most recently, in \textit{Commissioner ID 2004/943}, a lump sum payment for permanent injury occurring at work was considered not assessable as ordinary income or under CGT and ‘consequently no part of the amount received [was] included in the taxpayer’s assessable income’ but the decision did not directly address potential taxation as an ETP, perhaps because the employment had not been terminated.

\textsuperscript{149} \textit{Dibb} (2004) 55 ATR 786, 803 (Spender, Dowsett and Allsop JJ).
the case, the employer there denied all allegations, including that there was any personal injury sustained.

The same issue is presented for CGT purposes in seeking to access the s 118-37 exemption. As discussed above, a right to seek compensation is a CGT asset and the settlement of a cause of action will be a CGT event C2, giving rise to a potential capital gain. If, as would often be the case, an action arising from termination of employment includes multiple claims, on settlement of that action, the s 118-37 exemption will only be available for that part of the settlement sum which can be said to be identifiable as consideration in respect of the wrong or injury suffered personally or in one’s occupation.

The apportionment of sums for tax purposes has been predominantly considered in the context of dissecting sums into assessable income and non-assessable capital amounts prior to the introduction of the CGT. The decision of the High Court in *McLaurin v Federal Commissioner of Taxation*\(^\text{150}\) established the proposition that it is not appropriate to apportion a sum which is ‘in respect of a claim or claims for unliquidated damages only and is made or accepted under a compromise which treats it as a single,

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\(^{150}\) (1961) 104 CLR 381 (*McLaurin*). In this case, the taxpayer, who carried on business as a grazier, suffered damage from a fire which originated on land owned by the Railways Commission. The fire caused damage to the land, fencing and livestock and reduced the income earning capacity of the property for a year. The taxpayer commenced an action against the Commissioner of Railways for damages. The action was settled for a lesser sum. If it had been possible to apportion the sum across the claims, the amount representing loss of income and livestock would have been of an income nature (and therefore taxable) while sums representing loss of capital assets would have been capital (and therefore not taxable). Since the Court concluded that the sum could not be apportioned, it was considered as a whole. Given that the sum included both income and capital elements, the Court concluded that the capital (non-taxable) elements would be given priority and the whole sum was treated as capital.
undissected amount of damages.’\textsuperscript{151} This rule was also applied in *Allsop v Federal Commissioner of Taxation*,\textsuperscript{152} where the High Court concluded that the sum received on settlement of all claims represented compensation for both a liquidated claim and various unliquidated claims which could have been made.\textsuperscript{153} As the sum was by way of compromise of all these claims, it could not be apportioned and was considered as a whole as capital.\textsuperscript{154}

These principles may also be applied in the context of disputed terminations as the former employee may make various claims for damages, many of which will be unliquidated. When a settlement agreement is reached, the settlement will most usually include a release of all claims on the part of the former employee drafted in the broadest terms but since the former employer would be reluctant to admit any wrongdoing, no amount would be allocated to a particular claim. It would therefore not be possible, under the rules established by *McLaurin* and *Allsop*, for a court to apportion the sum to various claims and therefore establish any amount paid in respect of personal injury.\textsuperscript{155} This point alone may make both the CGT and ETP

\textsuperscript{151} Ibid 391 (Dixon CJ, Fullagar and Kitto JJ).
\textsuperscript{152} (1965) 113 CLR 341 (‘*Allsop*’).
\textsuperscript{153} In *Allsop*, the taxpayer had paid transport fees under state legislation which was later declared invalid. The taxpayer then sought to recover these fees and a settlement for a lesser amount was agreed upon which was accepted as in full settlement of all claims of any nature against the Commissioner of Motor Transport. Although the claim for the refund of fees paid was a claim for liquidated damages, the court considered that the taxpayer could also have claimed unliquidated damages in respect of unlawful interference with the taxpayer’s vehicles and business operations. All these claims and potential claims were compromised by the settlement agreement.
\textsuperscript{154} Ibid 351 (Barwick CJ and Taylor J).
\textsuperscript{155} This view is consistent with that adopted by the Commissioner in *Taxation Ruling TR 95/35* [206], where it was stated as follows:

It follows that if the compensation relates to a number of heads of claim, or causes of action, but the individual components of the compensation cannot
exemptions unavailable to employees where a settlement sum has been received on compromise of all claims related to a termination dispute.

6. CONCLUSION

The purpose of this article has been to highlight the taxation implications which arise from the characterisation of a receipt of an amount on settlement of an employment-related dispute as an ETP. The legislative history of the ETP provisions evidences no clear intention by the legislature to subject such payments to tax in the same manner as other employer-funded payments (such as golden handshakes) where in many cases the receipts would not be assessable otherwise. The current treatment arguably over-taxes such payments, and the position will be exacerbated when the proposed new rates schedule applicable to employer ETPs takes effect. This article has also endeavoured to open for reconsideration the treatment of compensation for injuries or damages of a personal nature as no clear policy is apparent from the various provisions. It is submitted that there is, at a minimum, a strong case for aligning the exemptions and for providing a mechanism whereby unallocated lump sums which clearly include a component for personal injury can be apportioned so as to trigger the operation of the exemptions.

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be determined or estimated, no part of the compensation can be said to relate to any particular claim.