TAX TREATMENT OF DAMAGES AND SETTLEMENT AMOUNTS

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March 9, 2017
Damages and Settlement Payments

Damages are money payable to a person as compensation for injury suffered.

Chamberlain v. The North American Accident Insurance Co., 1916 CanLII 334 (AB CA), at p. 301

In this presentation, I treat damages and settlement payments synonymously.
Why tax matters

- *Income Tax Act* (Canada) ("ITA") does not set out code for taxation of damages: tax results are governed by general provisions and case law
- Tax treatment depends on characterization of amount
- Receipt may be fully or partially taxed, or not taxed at all
- A payment may be fully deductible or not
- Tax treatment should be considered from outset of civil action: to assess tax, revenue authority may rely on position taken in action by party
Why tax matters

• Practice points
  • As a litigator, confirm in writing with your client that you are not providing tax advice
  • Connect client with tax counsel or obtain instructions to retain counsel for advice
Overview

1. Employment Law
2. Personal Injury
3. Commercial Litigation
Employment Law & Dismissals

• Query whether worker was employee or contractor in business on her own account
  • General principles:
    • was there an agreement;
    • control over the worker;
    • ownership of tools;
    • chance of profit; and
    • risk of loss
Key concept in this area: retiring allowance

Taxable under ITA subpara. 56(1)(a)(ii)

not including an amount received under an employee benefit plan, a retirement compensation arrangement or salary deferral arrangement
Employment Law & Dismissals

• Retiring allowance defined in ITA ss. 248(1): an amount received on or after retirement from office or employment recognizing long service; or in respect of loss of office or employment, whether or not received as or on account of damages
• Not including pension/death benefit or counseling service to employee
• Inclusions:
  • Unpaid sick leave likely retiring allowance
  • Unpaid accumulated vacation time likely not
Employment Law & Dismissals

- Planning opportunities
  - Retiring allowance taxed when received, so spreading payments over time could reduce tax at top marginal rate – may be bargaining chip in settlement
• Rollover to RRSP/RPP
  • Transitional rules make this confusing, but employees with years of service before 1996 may transfer part of retiring allowance directly to an RRSP/RPP (“eligible portion”)
  • Non-eligible piece can be transferred to if there is contribution room
Employment Law & Dismissals

• Consider also apportioning amongst heads of damage – amount may be partially: retiring allowance, tort damages, punitive
• T4A reporting and withholding to extent of any taxable amount (not transferred to RRSP/RPP)
• Withholding can waived if both payer and recipient agree and sign form
Employment Law & Dismissals

• Speaking of tort damages and employment
• Compensation for defamation or human rights violation likely not taxable
• Challenge: will employer admit in settlement documents to bad acts?
• Further challenge: how to benchmark the defamation or human rights amount?
  • Possible to use # of months of service
  • Using income as benchmark doesn’t necessarily make compensation “income”
Employment Law & Dismissals

• Apportionment of amounts determined by the CRA or Tax Court in accordance with their “true character”
• Apportionment must be reasonable and supported – fact driven exercise
• Nonetheless, way pleadings or settlement/release documents are written may be persuasive since drafting reflects parties’ intentions
Employment Law & Dismissals

- Characterization of Amounts
  - *Ahmad* case as example
  - Sued Ontario Hydro for breach of employment agreement
  - CRA called general damages retiring allowance
  - Tax Court said “no” – general damages were for Ontario Hydro ruining his career
  - Taxpayer stood his ground, lost his career and consequently self-respect and dignity
  - General damages compensated for that
Employment Law & Dismissals

• Characterization of Amounts
  • University dean who was passed over for teaching position for which qualified
  • Sued and received damages
  • CRA called it retiring allowance
  • Tax Court held it was for loss of future position and untethered from dean role
Employment Law & Dismissals

• Query also whether plaintiff was ever employed
  • Schwartz SCC
  • Accepted corporate job and quit law practice
  • Company withdrew the offer and paid $400k for release
  • SCC held not ss. 248(1) retiring allowance
• ITA subpara. 56(1)(a)(ii) did not provide for tax on settlements for loss of intended employment
• General charging provision in s. 3 not applicable, because general provision trumped by specific retiring allowance provision
• Taxpayer never employed so no nexus between settlement and employment
• Legal fees incurred to obtain retiring allowance may be deductible (more specifically, reimbursement of fees taxable under ITA ss. 56(1)(l.1) but deductible under ss. 60(o.1))

• Any allocation of damages/settlement to reimbursement of legal fees must be supportable, not fanciful

• If you lose – see para. 8(1)(b) deduction
Employment Law & Dismissals

• Pre-judgment interest
  • Tracks tax treatment of underlying amounts
  • Interest non-taxable to extent award not taxable
Overview

1. Employment Law
2. Personal Injury
3. Commercial Litigation
Personal Injury

- General ITA rules and case law principles apply to deduction/inclusion
- Special and general damages non-taxable
- Special - typically out of pocket expenses (e.g. medical) or accrued and future lost earnings
- General – pain and suffering, loss of amenities of life, loss of earning capacity etc.
• Whether damages based on accrued or lost future earnings could be characterized as employment income is a question of fact
• But typically even if damages measured by lost income, should not be taxed
• Again, accrued interest attributable to non-taxable aware would be non-taxable
Personal Injury

- *Cirella* case (FCTD 1978)
  - CRA determined compensation for loss of earnings was taxable
  - Court held that commercial case law not applicable – injured person not a damaged business asset
• *Forest* case (FCA 2007)
  • Sued employer for damages for harassment ($100k “moral” damages and $100k exemplary) for violating his fundamental rights including to honour, respect, dignity and reputation, by continuously harassing him
  • Received $152k to abandon his suit
• *Forest* case (FCA 2007)
  • CRA assessed based on retiring allowance
  • TCC agreed
  • FCA held that only $23k was in exchange for voluntarily leaving employment, pursuant to employer’s policy so the rest was non-taxable
• *Forest* case
  • Moral to the story – he lost at trial it seems because he argued that all of the settlement was for harassment and TCC judge could not agree
  • Arguing apportionment would have been more advisable?
• **Mathew** (TCC 2012)
  • Allocation/characterization needs to be supportable
  • Don’t want a court to describe a settlement as “an attempt to camouflage substantial amounts of income … received for work … as tax free damages for pain and suffering.”
Overview

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Commercial Disputes - Recipient

• At high level/general rule: tax treatment of an amount tracks treatment of thing that was lost
• Compensation for lost income in commercial context typically taxed as income
• Compensation for loss of, or damage to, capital property likely capital receipt
• *Surrogatum* principle
Commercial Disputes - Recipient

• Can be confusing because again compensation for loss of an income producing asset could be calculated using lost income as benchmark, but still be capital receipt
• As very loose guideline, consider tree/fruit analogy
  • Tree is capital asset producing fruit
  • Fruit is income
• Is compensation for loss of tree or production from tree (i.e. income)
• As noted above, amounts in commercial context may be categorized as either:
  • Paid for purpose of gaining or producing income (fully and currently deductible)
  • Paid on capital account (not deductible on a current basis but capital cost allowance)
  • Eligible capital expenditure (deductible in accordance with specific ITA provisions)
• In reality, capital gain treatment is most likely
• Not surprisingly, punitive damages not taxable as not tethered to either capital asset or lost income
• Planning opportunity
  • As with other types of damages, in commercial context consider allocation between heads of damage
Commercial Disputes - Recipient

• Important that pleadings / court order / settlement document be explicit
  • As always, allocation needs to be reasonable and supportable
• Consider also symmetry between how the payer and recipient would treat amount(s)
  • Inconsistent treatment may be challenging to justify to CRA
• Pre and post judgment interest taxable
  • Unless interest connected with a non-taxable receipt
Commercial Disputes - Payer

- Payer’s perspective
  - Outlays may be fully deductible or capital expenditures
  - Key provisions s. 9 and paras. 18(1)(a) and (b)
Commercial Disputes - Payer

• Payer’s perspective
  • Subsection 9(1) first queries whether claiming deduction was consistent with “ordinary principles of commercial trading or well accepted principles of business”
    Symes SCC 1993
Beyond that general test:

- 18(1)(a) limits deductibility of outlays except to extent made or incurred for purpose of gaining or producing income from business or property
- 18(1)(b) limits deductibility of outlays in respect of loss or replacement of capital, obsolescence or depletion except as expressly provided for in ITA
• Payer’s perspective
  • Full deduction likely where damages paid as result of event incidental to normal course of business or where connected with inherent risk of business
  • Where payment is capital in nature, deduction over time for capital cost allowance
Commercial Disputes - Payer

- Assets from which income derives: enduring benefit concept
- Enduring benefit means more than benefit derived from a long-lived asset
- Could also mean a benefit arising from an expenditure associated with breaking a long-term lease or contract
Commercial Disputes - Payer

• Payer’s perspective
  • Punitive damages likely deductible if incurred for purpose of earning income from business or property
  • Query whether public policy would bar this
• *McNeill* (FCA) extended 65302 (SCC – deductibility of fines & penalties)
• Breach of contract was intentional and damage deliberate, but bad acts were for purpose of earning income from business, thus deductible
• Still possible acts could be so repulsive that they could be disconnected from purpose of earning income
The end