

## TAX TREATMENT OF PAYMENTS RECEIVED AT THE END OF THE WORKING RELATIONSHIP

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### 1. Termination Payments

There are many different types of payments that are made to an individual by a business at the end of their working relationship. Some are simply the result of a prior agreement between the individual and the business, some are voluntary payments made by the business as a sign of goodwill or recognition of good service, and others are only made after the individual has engaged the services of a good workplace lawyer.

Examples include:

- (a) payment of accrued leave entitlements,
- (b) “golden handshake” termination payment,
- (c) redundancy payment,
- (d) compensation payment for breach of the employment contract,
- (e) compensation payment for some mistreatment or injury suffered during the working relationship.

The payment type and tax treatment of each payment will depend on how the employment was terminated. Therefore, it is crucial to identify what each payment is in relation to according to the surrounding circumstances and documentary evidence.

The tax treatment of these payments varies depending on how the payment is characterized – some will:

- (a) be treated as ordinary income of the individual and taxed at their marginal tax rate,
- (b) receive concessional treatment, and
- (c) be exempt from tax.

Most payments received at the end of a working relationship will be income in character and exposed to some level of tax. However, there are occasions where a payment made is capital in character (for example, a compensation payment for an injury they suffered). To further complicate the position, there are also provisions of the income tax legislation that stipulate that certain payments which otherwise might be capital payments are taxed

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as income – for example the so-called “employment termination payments” or “genuine redundancy payments”.

This means that care must be taken when characterising a settlement payment that is made up of various components, in particular payments that have components relating to personal injury or an illness that has resulted in the taxpayer being terminated from their employment. The tax consequences for each component can vary substantially depending on the nature of the payment.

## 2. Taxation of ordinary income

Payments that are ordinary income are taxed at the individual’s marginal tax rate. The only question is the timing of the derivation of that income. Namely, the opportunity to defer derivation to a following tax year not only may delay the payment but may also allow a lower rate of marginal tax rate to apply.

Where an individual is expecting to earn less income in the income year after their relationship with the business ends, it might be advantageous to “derive” the income in the following income year, so that it is taxed at a lower rate or falls into the tax-free threshold.

### *Case study example- timing of ETP’s and redundancy payments*

*Your firm asked us to provide advice on a settlement sum between an employee and previous employer. The employee had been working with the employer for 4 years. The settlement sum was made up of a redundancy payment and an ETP. It was agreed that the settlement amount would be paid in installments across two financial years. The employee had already earned substantial income in the current financial year and did not intend to work in the next financial year after her termination settlement had been completed.*

*As genuine redundancy payments received are tax free up to a limit based on the amount of years of service with the employer<sup>1</sup> and ETP’s are capped at \$195,000<sup>2</sup>, we suggested that the employer paid the redundancy payment to the taxpayer in the current financial year and the ETP in the next. Namely, the \$195,000 cap is reduced by any other income earned in the income year either before or after receiving the ETP and therefore it would be more advantageous for the taxpayer to receive the ETP amount in the year she was not going to make any other income.*

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<sup>1</sup> Section 83-170 of the *Income Tax Assessment Act 1997* (“ITAA 1997”)

<sup>2</sup> Section 82-160 of the ITAA 1997. The ETP cap amount for the 2016-2017 income year is \$195,000. This amount is indexed annually.

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The rule that will apply for almost all of your clients is that the payment will be “derived” when they receive it (“actual receipt”), or when it is dealt with in a way that they directed or have agreed to (“constructive receipt”).

***Example – constructive receipt***

*Stephen’s employment with his employer is due to end on 15 June 2014. Under his employment agreement, on that day he is entitled to receive a bonus payment of \$100,000. Stephen asks his employer not to pay him the bonus payment until July. Stephen is fully entitled to the payment on 15 June 2014, and on that date it was dealt with as agreed with the employer, so the income is “derived” in the 2014 income year (constructive receipt) even though he did not actually receive it until the 2015 income year.*

***Example - deferral***

*Same facts as above except Stephen’s employer disputes the entitlement to the bonus payment, and does not pay. After legal argument, the employer eventually pays the bonus in the 2015 year.*

*Here, Stephen was entitled to receive the payment in the 2014 income year, but did not actually receive it until the 2015 income year. Because the amount was not paid to Stephen or dealt with as he directed or agreed until the 2015 income year, it is “derived” in that year, and taxed at the lower rate.*

Note that constructive receipt will not operate where an agreement is reached to deal with the income before the entitlement to the income arises. Namely, if prior to termination the contract is amended so that the bonus is payable say 6 months after termination then that bonus payment is derived when actually received.

### **3. Taxation of capital payments**

Capital payments were once tax-free (prior to 19 September 1985), but following the introduction of capital gains tax (CGT), a capital gain will be included as assessable income and taxed at their marginal rates – though discounts, concessions and exemptions can apply.

There are, however, some important differences in the taxation of capital gains that need to be remembered, and some exemptions or concessions that may apply to capital payments.

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### ***Timing of taxation of capital gains***

Under the CGT provisions, the income year in which a capital gain is included in the individual's assessable income is determined by the time that the relevant "CGT Event" occurs (and not when the payment is received). Each different CGT Event has set rules that decide when the Event occurs, and therefore when the tax on the gain is assessed and payable.<sup>3</sup>

As a general rule, where a CGT Event occurs because an agreement has been made between two parties, the CGT Event is taken to have occurred at the time the agreement was made. The classic example is on the sale of real estate the time of disposal (and acquisition) is generally the date of the contract and not the date of settlement of the contract.

### ***General 50% discount on capital gains for individuals***

An individual is entitled to a 50% discount on any capital gain they make in relation to an asset they have held for at least 12 months. This means that it will almost always be preferable for an individual to have a payment classified as a capital payment rather than a payment of income, with the important stipulation that the asset must have been held by the individual for at least 12 months.<sup>4</sup>

#### ***Example***

*Rodney has been partner in an accounting firm for three years. Following a disagreement with the other partners, he agrees to terminate as a partner and receive \$300,000 for his share of the goodwill in the partnership (payable in 3 equal annual payments) and a payment of \$200,000 as a restraint of trade. On 15 June 2013 an agreement is signed. The capital gain derived in respect of the goodwill payment is taxable in the 2013 tax year – the date of the contract despite the payments are not made entirely in that year. Because he held this asset for more than 12 months, a 50% discount is applied.*

*For the restraint of trade (creation of a contractual right, ie CGT Event D1), the proceeds are \$200,000, which we will assume is also the capital gain. Again, the timing of the event is the time the contract was executed and therefore assessable in the 2013 year. However the 50% discount will not apply. What Rodney has done is to create a contractual right acquired by the continuing partners – the right restraining Rodney from competing. That contractual right did not exist prior to the contract date so the 12 month rule did not apply.*

### ***Exemption for capital payments made as compensation for injury wrong, etc***

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<sup>3</sup> See Division 104 of the ITAA 1997 for all the CGT Events

<sup>4</sup> Division 115 of the ITAA 1997

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Any capital gain (or loss) that is realised by an individual is disregarded (ie, tax free)<sup>5</sup> if it is:

1. compensation or damages received for “any wrong or injury” suffered in their occupation;<sup>6</sup> or
2. compensation or damages received for any “wrong, injury or illness” suffered personally by the individual or their relative.<sup>7</sup>

This means that, ordinarily, most compensation payments made to an individual, whether under a court order or under an agreement in settlement of a legal dispute, will be entirely tax free. A classic example of this provision in its application is damages award for defamation. The principal of our firm likes to call it “the redundancy payment for retired politicians!”

This provision is very important for workplace lawyers and we will be discussing this in more detail further in the paper under “personal injury”.

Note that there are many cases where a payment is caught under the CGT provisions and also is caught under the normal or ordinary income tax provisions. In such cases the income tax provisions prevail over the CGT provisions.

For example, compensation for losing an income stream will fall into section 118-37 but that does not mean it is a payment exempt from tax. Such payments are also treated as ordinary income and taxed under those provisions.

Another exception is payments that are caught by the employment termination payment (‘ETP’s) provisions, more of which later.

### ***Example***

*Susan was contracted to work for a company for a year, but after three months she is sexually assaulted by the CEO. When she reports the assault she is dismissed with no warning.*

*The matter is settled as follows*

- (a) *\$200,000, representing the income she would have earned during the remaining 9 months of her contract, and*
- (b) *\$500,000, representing compensation for the pain and suffering she experienced as a result of the assault.*

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<sup>5</sup> Section 118-37(1) of the ITAA 1997

<sup>6</sup> Section 118-37(1)(a) (i) of the ITAA 1997

<sup>7</sup> Section 118-37(1)(a) (ii) of the ITAA 1997

*Here, the \$200,000 payment replaces income, and is included in her assessable income. The \$500,000 is a capital payment that is compensation for a wrong or injury she suffered personally, and exempt from CGT under section 118-37(1)(b). Susan will pay no tax on this amount. However it is still necessary to consider the ETP provisions (see next)*

#### 4. Taxation of Genuine Redundancy Payments

The **tax free amount** of a **genuine redundancy payment** or an early retirement scheme is **not an ETP** – see 82-135(e).

ETPs are discussed further under section 5 below. An ETP is a lump sum payment made in consequence of the termination of an employee's employment or office, and when received by the employee whose employment is terminated is a 'life benefit termination payment' pursuant to subdivision 82-A of the ITAA 1997. In addition to the tax free amount of a genuine redundancy payment not being an ETP, unused annual leave and long service leave entitlements and superannuation benefits are also not ETPs.

To be an ETP and receive concessional tax treatment, it must be made within 12 months of termination. Payments made outside the 12 month period will be included in the employee's assessable income and taxed at the marginal tax rate (note that this 12 month rules **does not apply** to the **taxable component** of **genuine redundancy payment**).

There are four necessary components to satisfy a genuine redundancy payment<sup>8</sup>:

1. The **payment** being tested must be **received *in consequence of an employee's termination***.
2. That termination must involve the employee being **dismissed from employment**.
3. That dismissal must be **caused by the redundancy** of the employee's position.
4. The redundancy payment must be made **genuinely** because of a redundancy

The satisfaction of these requirements establishes the essential character of the payment.

In any settlement, you should have the employer affirm an employee's position is being made *genuinely redundant*. Eg, the employee is receiving the payment because the job he was doing is abolished; that is, the employer has made a decision that the job the employee was doing no longer exists, and the employment is to be terminated.

A genuine redundancy has tax-free treatment up to a certain limit as discussed further below. If the redundancy does not meet the definition of genuine redundancy then it will be taxed under the normal employment termination payment rules.

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<sup>8</sup> Section 83-175 of the ITAA 1997. Each of these concepts are considered in the Commissioner of Taxation's Taxation Ruling TR 2009/2, which discusses the four necessary components and conditions to satisfy a genuine redundancy payment.

In addition to the basic requirements for a genuine redundancy payment found in subsection 83-175(1), there are further conditions<sup>9</sup> that must also be satisfied before a payment can be treated as a genuine redundancy payment:

1. the dismissed employee is not older than specified age limits<sup>10</sup>
2. the termination is not at the end of a fixed period of employment<sup>11</sup>
3. the actual amount paid is not greater than the amount that could reasonably be expected had the parties been dealing at arm's length, in the event that the employer and employee are in fact not dealing at arm's length in relation to the dismissal<sup>12</sup>
4. there is no arrangement entered into between the employer and the employee or the employer and another entity to employ the dismissed employee after the termination<sup>13</sup>; and
5. the payment is not in lieu of superannuation benefits<sup>14</sup>

If all the above requirements are satisfied then the payment will be tax-free up to the limit calculated by a set formula based on the number of years of service<sup>15</sup>.

The tax-free limit is determined by:

Base amount + (service amount × number of years of service)

The base amount and service amount are indexed annually in accordance with ss 960-270, 960-275 and 960-280 of the ITAA 1997.

For example, for 2016-17 the tax free limit is \$9,936 (base amount), plus \$4,969 (service amount) multiplied by the years of service. Therefore, for 25 years service, the tax-free limit for an employee for the year ending 30 June 2017 is:

$$\$9,936 + (\$4,969 \times 25) = \$9,936 + \$124,225 = \$134,161$$

The amount paid *up to this limit* is *not* an ETP.

The amount paid *over this limit* is the excess amount, which will then form part of the ETP. That is, any amount in excess of the tax-free amount is taxed as an ETP under s82-135.

<sup>9</sup> Section 83 – 175 (2) of the ITAA 1997

<sup>10</sup> Section 83 -175 (2) (a) of the ITAA 1997 provides that an employee must be less than 65 years old at the time of dismissal for a redundancy payment to qualify as a genuine redundancy payment. However, if the employment of a particular employee would have otherwise terminated at a younger age than 65, the employee must be dismissed before that time. This younger age becomes the employee's age-based limit in these circumstances. See also paragraphs 34 and 35 of TR 2009/2.

<sup>11</sup> See paragraphs 36 to 39 of TR 2009/2

<sup>12</sup> See paragraphs 40 to 49 of TR 2009/2

<sup>13</sup> See paragraphs 50 to 52 of TR 2009/2

<sup>14</sup> See paragraphs 53 and 54 of TR 2009/2

<sup>15</sup> Section 83-170 of the ITAA 1997

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It is noted that the ETP concessional cap amount for the year ended 30 June 2017 under section 82-160 is \$195,000.

### ***Case Study – Genuine Redundancy***

*David is a 60 year old employee and director of a company he worked at for 25 years. His employment is terminated, and is a genuine redundancy. If the employee accepts the redundancy, the payments are as follows:*

- 1. Approximately \$154,000 payment is being made in respect to 7 months' pay in lieu of notice and \$66,000 payment is being made in respect to 3 months' severance pay in accordance with the requirements of the Fair Work Act, being total of approximately \$220,000.*
- 2. David will be working out approximately 4 months' actual notice until his termination date on 11 December 2016. David's other taxable income for the year ended 30 June 2017 calculated using the base salary of \$267,625 exclusive of superannuation (and assuming he works out the actual notice to 11 December = 164 days in the current financial year) is approximately \$120,000.*
- 3. David has accrued approximately \$180,000 of annual leave entitlements and \$115,000 of long service leave entitlements.*

*You need to work out the amount that David would not have received if he had not been redundant. Assume this is the total of \$220,000 in point 1. This is subject to the ETP cap (\$195,000). The tax-free part of the payment is \$134,161 based on the 25 years service.*

*The balance of the redundancy payment (\$220,000 less \$134,161) being \$85,839 is taxed as an ETP.*

*To calculate the ETP, you add the balance of the redundancy payment (\$85,839) plus the payment of \$120,000 (point 2) giving total \$205,839. Of the first \$195,000, this will be taxed concessionaly at 32% because it is under the ETP cap, then the balance of \$10,839 will be added to the payments made for the accrued annual leave and long service leave being respectively \$180,000 and \$115,000, total approx. \$305,839 and withholding on this amount will be at the highest rate 49%.*

*Note that accrued annual leave and long service leave are not taxed as an ETP.*

## 5. Employment Termination Payments (“ETPs”)

Divisions 82 and 83 of the ITAA 1997 have particular rules for the taxation of payments received by an individual on the termination of their employment.

These rules generally:

- (a) Can catch payments that would otherwise be ordinary income or capital payments.
- (b) Replace the way the payments are taxed so that the payments are included in the assessable income of the individual, but parts of the payments are taxed at lower rates.

The rules broadly apply as follows<sup>16</sup>:

1. the payment is received “*in consequence of the termination of [the employee’s] employment*”,
2. is received within 12 months of the termination of employment, and
3. is not any of the exceptions in section 82-135<sup>17</sup>.

The exclusions under section 82-135 include for example superannuation payments, leave entitlements, genuinely redundancy payments and certain compensation payments such as personal injury payments.

### Examples of termination payments that are ETPS

The employer payments listed here <b>may be ETPs</b> when paid in consequence of termination of employment	The employer payments listed here <b>are not ETPs</b> and are taxed under different rules
<ul style="list-style-type: none"> <li>• unused rostered days off (RDOs)</li> <li>• in lieu of notice</li> <li>• unused sick leave</li> <li>• a gratuity or “golden handshake”</li> <li>• compensation for loss of job</li> <li>• compensation for wrongful dismissal               <ul style="list-style-type: none"> <li>• because of the employee’s invalidity (permanent disability, other than compensation for personal injury)</li> </ul> </li> <li>• genuine redundancy and retirement scheme payments <b>in excess of the tax-free amount</b></li> </ul>	<ul style="list-style-type: none"> <li>• unused annual leave and/or leave loading</li> <li>• unused long service leave <sup>18</sup></li> <li>• salary, wages and allowances owing to the employee, for work done or leave already taken</li> <li>• compensation for personal injury</li> <li>• payment for restraint of trade               <ul style="list-style-type: none"> <li>• an advance or loan</li> <li>• excessive payments that are deemed to be dividends for tax purposes</li> </ul> </li> <li>• genuine redundancy and early retirement scheme payments that are</li> </ul>

<sup>16</sup> Section 82-130 of the ITAA 1997

<sup>17</sup> ITAA 1997

<sup>18</sup> Payments of accrued annual leave and long service leave entitlements are included in assessable income and:

- (a) taxed at a rate of 32% if it was made at the same time as a genuine redundancy payment, and
- (b) taxed at the individual’s marginal tax rate otherwise.

<ul style="list-style-type: none"> <li>• certain payments after the death of an employee</li> </ul>	<p><b>within the tax free amount</b> are not subject to tax (see below). If the payment is over the tax free amount, the excess is an ETP</p> <ul style="list-style-type: none"> <li>• a superannuation benefit (ie a lump sum or income stream from a superannuation fund)</li> <li>• pension or annuity payments (whether a superannuation benefit or not)</li> <li>• a payment made by a company or trust to a capital gains tax (CGT) concession holder (an employee), being the CGT exempt amount under the CGT retirement exemption</li> <li>• certain foreign termination payments arising out of foreign employment <ul style="list-style-type: none"> <li>• an amount received in commutation of a pension from a constitutionally protected fund and wholly applied to pay a surcharge liability</li> <li>• an amount received in commutation of a pension payable by a superannuation provider and wholly applied to pay a surcharge liability <ul style="list-style-type: none"> <li>• an amount included in assessable income under the employee share scheme rules</li> </ul> </li> </ul> </li> </ul>
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### Taxation of an ETP

There are two components of an ETP<sup>19</sup>, being:

- (a) a taxable component (which attracts a tax offset on the 'ETP cap amount'); and
- (b) a tax-free component (which is non-assessable non-exempt income<sup>20</sup>).

#### *Taxable Component*

The taxable component of an ETP is the amount that is not tax-free. The taxable component is included in assessable income, but a tax offset ensures that the tax rate cannot be higher than a rate that varies according to the age of the employee.

A taxpayer aged at least preservation age (see table below) cannot be taxed any higher than 17% (up to the ETP cap amount<sup>21</sup>) and a taxpayer aged below the preservation age up to the ETP cap amount cannot be taxed any higher than 32%. Any amounts that

<sup>19</sup> Section 82-10 of the ITAA 1997

<sup>20</sup> Section 82-140 of the ITAA 1997

<sup>21</sup> The ETP cap for the 2016/2017 year is \$195,000

exceed the ETP cap is taxed at 49%;

### *Preservation age*

Date of Birth	Preservation Age
Before 1 July 1960	55
1 July 1960–30 June 1961	56
1 July 1961–30 June 1962	57
1 July 1962–30 June 1963	58
1 July 1963–30 June 1964	59
After 30 June 1964	60

### *Tax-free component of an ETP*

The tax-free component is so much of the payment that consists of an invalidity segment and a pre-July 1983 segment.<sup>22</sup>

An ETP includes a “pre-July 83 segment” if any of the employment to which the payment relates occurred before 1 July 1983.

### *Invalidity Payment*

The requirements for the invalidity component is set out in section 82-150<sup>23</sup>, and they are:

- (a) The payment was made to a person because they stopped being gainfully employed; and
- (b) The person stopped being gainfully employed because they suffered from ill-health (whether physical or mental); and
- (c) The gainful employment stopped before the persons last retirement day; and
- (d) They obtain 2 medical certificates certifying that because of the ill-health it is unlikely that the person can ever be gainfully employed in the capacity for which they are reasonably qualified because of education, experience or training.

The definition of “gainfully employed” is defined in the ITAA 1997 to mean “*employed or self-employed for gain or reward in any business, trade, profession, vocation, calling, occupation or employment.*”<sup>24</sup>

Because points (a) and (b), above, are separate conditions, the making of the payment does not need to be motivated by the health issues of the employee – the payment just needs to be made because the employee stopped being gainfully employed.

<sup>22</sup> Section 82-140 of the ITAA 1997

<sup>23</sup> ITAA 1997

<sup>24</sup> Section 995-1 of the ITAA 1997

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Further, the invalidity test does not require the employee's illness to prevent them from ever being employed but whether they are likely to be unable ever to be employed in a capacity for which the taxpayer is reasonably qualified because of education, training or experience. In the case of *Pitcher*, Ryan J stated in paragraph 53<sup>25</sup>:

*"I accept that the statutory test erected by s 27G (b)(i)(B) is not whether the taxpayer will ever be fit for employment but whether he or she is likely to be unable ever to be employed in a capacity for which the taxpayer is reasonably qualified because of education, training or experience."*

### ***Case example – invalidity payment***

*We received a deed of release from a taxpayer who had already entered into a deed of release with her previous employer.*

*The taxpayer had worked in a large investment-banking firm as an Executive Director specialising in derivate sales. The role was very demanding with long working hours and a high level of stress. Due to an acute infection, the taxpayer developed chronic fatigue syndrome, which resulted in a decline in her working abilities. The taxpayer's employer was well aware of her illness and allowed her to work part-time when her illness became worse.*

*A dispute between the taxpayer and her manager triggered a set back in the taxpayer's health and her illness deteriorated. This resulted in her ability to continue working. Shortly after this event, the taxpayer entered into a deed of release with her employer. The deed provided that the taxpayer was being terminated on the basis of redundancy. It did not refer to her CFS illness. A redundancy payment of \$900,000 was made to the taxpayer.*

*This was a detrimental error on the drafter's behalf.*

*Even though the taxpayer had more than two medical certificates providing that because of the ill-health it is unlikely that she could ever be gainfully employed in the capacity for which she is reasonably qualified because of education, experience or training, she was not able to get supporting evidence from her employer providing that that she had stopped being gainfully employed due to her illness.*

*At this point, after a deed of release has been entered into determining that her employment was terminated on the basis of redundancy, it is difficult, without any*

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<sup>25</sup> *Federal Commissioner of Taxation v. Pitcher* [2005] FCA 1154; 2005 ATC 4813; (2005) 60 ATR 424

evidence from the employer, to argue that her termination was anything but a redundancy.

*In this particular example, a private ruling was submitted. The Commissioner determined that the settlement amount was a redundancy payment on the basis of the clear wording of the deed of release. This meant that the \$900,000 (minus the redundancy tax free amount, which in this case was minimal as it is based on the number of years of service) would be subject to the taxpayer's marginal tax rate.*

This is a good example of how important it is to correctly characterize the termination payment in a deed of release and also the importance of getting tax advice before a deed is entered into.

## 6. Classification of payments received on termination of employment

Because “*employment termination payment*” is defined widely, it is safest when classifying payments that are received by an employee after or shortly before the termination of their employment to assume that they are an ETP unless they fall within a few specific categories of payments that are not “caught” by the ETP rules (see in above table).

The most common categories are:

- (a) payments where there is no “termination of employment”
- (b) payments that are not made “in consequence of” the termination,
- (c) payments that are genuine redundancy payments,
- (d) payments that are payments for, or in respect of, “personal injury” to the individual “so far as the payment is reasonable having regard to the nature of the personal injury and its likely effect on [the individual’s] capacity to derive income from personal exertion”,
- (e) payments that are reimbursement of legal expenses.

### No termination of employment

Section 80-5 of the ITAA 1997 provides that, for the purposes of Divisions 82 and 83 (ie the ETP rules), “employment” includes the holding of an office. This means that where a director of a company receives a payment on his retirement as a director, the payment may be an ETP even where there was no employment at general law.

Where a partner leaves a partnership there is no employment and therefore any payment received is not caught by the ETP provisions. However, in *FCT v Sealy* (1987) 19 ATR 582, a partner in a grazing partnership was the “managing partner”. When he left the partnership the Federal Court held that he was leaving the “office” of managing partner.

### Payment not in consequence of the termination

A payment is only an ETP if it is made “*in consequence of*” the termination of the employment.

In Taxation Ruling TR 2003/13 the Commissioner of Taxation stated that this means that a causal connection is required between the termination and the payment. *That is, but for the termination, the payment would not have been paid.*

There is no requirement that the termination is the dominant cause of the payment, only that it is some causal connection.

In *Applicant v Federal Commissioner of Taxation* [2005] AATA 583, 59 ATR 1161:

- the taxpayer commenced proceedings against his employer claiming among other things for compensation for hurt, humiliation and distress he suffered during his employment,
- the following day, the employer suspended him from his duties,
- subsequently, terms of settlement were reached and a deed of release executed, including terms that:
  - he would receive a “termination payment” of \$3.176 million, and
  - his employment was terminated on the date of execution of the deed.

The taxpayer argued that the payment was compensation for the hurt, etc he suffered during the course of his employment, and was not made “in consequence” of the termination.

The AAT held that because the termination and the payment were effected by the same deed, the individual would not have received the payment unless the employment was terminated, which was a sufficient causal connection to establish that the payment was an ETP.

Similarly, in *An employee v Federal Commissioner of Taxation* (2010) ATR 999; [2010] AATA 912:

- the taxpayer resigned from a position as finance director,
- the taxpayer subsequently claimed breaches of the *Age Discrimination Act* and that he had been bullied and harassed during his employment which caused post-traumatic stress disorder,
- terms of settlement were reached, and a deed of release executed including terms that:
  - he would receive payment of \$395,000,
  - he would release the employer from all claims he had or may have had against the employer, and
  - “claims” was defined to include actions, damages etc arising from his employment, and the termination of the employment.

Because “claims” included matters arising from the termination of the employment, the AAT found that the \$395,000 was made in consequence of the termination, and the whole payment considered an ETP.

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Clearly, care needs to be taken in preparing deeds of release to ensure that any payments that are made to an individual that are not related to the termination of their employment should be clearly separated from anything to do with the termination of the employment.

### Personal Injury

One of the most common questions that arise for workplace lawyers is whether a payment is in respect of a “personal injury” to the individual “so far as the payment is reasonable having regard to the nature of the personal injury and its likely effect on [the individual’s] capacity to derive income from personal exertion”.

Section 82-135 (i) of the ITAA 1997 provides that “*a capital payment for, or in respect of, personal injury*” is excluded as an ETP.

This exclusion is for a payment or benefit that compensates or reimburses a person for or in respect of a particular injury. Section 82-135(i) only applies to the extent the amount is **reasonable** having regard to the nature of the injury and its likely effect on the capacity of the taxpayer to derive personal exertion income.

In *Federal Commissioner of Taxation v. Scully* (2000) 201 CLR 148 the High Court, in considering former paragraph (n) in section 27A(1), held that compensation must be calculated by reference to the nature and extent of the injury or likely loss to the taxpayer. The payment in *Scully* was held not to be in respect of personal injury. *In our opinion, the payment in this case cannot be characterised as consideration... in respect of, personal injury. The fact that the payment is not calculated by reference to the nature and extent of the injury or likely loss to the respondent and the fact that the other benefits are similar to that for total and permanent disablement point inevitably to the conclusion that the payment was consideration... for, or in respect of the respondent’s termination of employment and her rights under the Trust Deed and was not consideration... for, or in respect of her injury.*

In *Dibb v FCT* (2004) 55 ATR 786, the Full Federal Court had this to say about personal injuries at paragraph [45], quoting with approval the judgment of Heery J in the lower court:

*[45] As to this matter, the reasons of the primary judge were as follows:*

...

*[35] “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: FCT v Scully (2000) 201 CLR 148 at [28]; 43 ATR 718 at 727; 2000 ATC 4111 at 4119, Graham v Robinson [1992] VR 279. However, even accepting that some of the complaints of damage the applicant raised in the Federal Court proceeding consisted of anxiety and depression and thus “personal injury”, the Commissioner was correct in concluding there was no way of*

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*dissecting the total settlement sum to include an amount for such a payment: McLaurin v FCT (1961) 104 CLR 381.”*

In order for an amount to fall within the exclusion from the definition of an ETP under section 82-135(i) it must relate to an injury which

- (a) encompasses injury or disease of a physical or psychological nature and would not extend to anguish, distress or embarrassment of the kind traditionally taken into account in assessing damages for defamation; and
- (b) must be an identifiable amount which has been calculated in respect of the injury and which has not been calculated in respect of entitlement under other heads of a settlement payment.

From the comments of Heery J quoted above, it is clear that medically diagnosed stress, anxiety and depression can constitute “personal injury” for the purposes of section 82-135(i).

Care should be taken to ensure that any Deed of Release relating to the Settlement Payment clearly identifies the Personal Injury Payment as being made in relation to your personal injury, and is distinguished from other components of the Settlement Payment.

This could be achieved by, for example:

- (a) noting in the recitals that allegations and claims were made that, among other things, you suffered personal injury in the form of medically diagnosed stress, anxiety and depression,
- (b) ensuring that amount of the Personal Injury Payment is set out in a way that it is clearly distinguished from the other components of the Settlement Payment, and
- (c) ensuring that the Personal Injury Payment is described as being in settlement of the claims made by you in relation to the personal injury, and nothing else.

In circumstances where:

- the parties have settled a dispute on a commercial basis, and given due consideration to the appropriate way to apportion the total settlement payment into separate identifiable components,
- as part of that consideration, evidence has been provided concerning the extent of the personal injury and its effect on the injured party’s capacity to derive income, and
- the parties come to an agreement as to the amount that is “reasonable” to pay in respect of the personal injury, and record that agreement in a Deed of Release,

we can see no basis on which the ATO could find that the amount is not “reasonable”, even where that amount is more it might be expected to have been awarded by a court.

### *Caution re Personal Injury*

Damages suffered as “*hurt, humiliation and suffering*”, are not considered to be “personal injury” for the purposes of section 82-135(i).

The wording of a Deed of Release should make it clear that the Damages Payment relates to the personal injury suffered by the employee and relates to personal injury in the form of medically diagnosed stress, anxiety and depression.

However, if the employee is seeking workers’ compensation in respect of the matter then such wording as stated above may not be appropriate – compromises may need to be considered.

### **The Legal Costs Payment**

A question that is often asked by workplace lawyers is how the reimbursement of legal fees should be paid and worded in the deed of release.

The reimbursement of legal costs is not a payment made in consequence of the termination of your client’s employment, and is not an ETP. This is confirmed in Taxation Ruling TR 2012/8, issued by the ATO on 28 November 2012. The legal fees the client pays is also not tax deductible.

As the Legal Costs Payment is an amount the client will receive to reimburse legal costs incurred in resolving the dispute. The amount will be tax-free. However, if the Legal Costs Payment is paid directly to the client, they will be required to pay the GST on any payment in respect of the legal costs. If, on the other hand, you issue a Harmer’s invoice direct to the employer for the amount of the Legal Costs Payment, the employer will be able to claim credits for any GST paid.

We note also that Taxation Ruling TR 2012/8 clearly states that the reimbursement of legal costs in matters such as these is not a fringe benefit, as it is not paid by the employer in relation to the client’s employment or former employment.

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