

When compensation can prove taxing

Elliot Elsey explains the tax treatment of compensation and the need for practitioners to secure expert advice from tax specialists



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When conducting litigation, a key concern is obtaining certainty of outcome. However, the tax treatment of any compensation is all too often overlooked. Not all types of compensation are subject to a tax liability, but a number are.

As practitioners, we need to have those issues in mind when considering the potential outcomes and level of compensation sought in any dispute. Timely, practical advice (and more than likely input from tax specialists) will ensure the best outcome for clients and avoid potential negligence.

WHAT TAX IS PAYABLE?

Any type of compensation will ultimately relate to something of value, which will potentially be subject to tax.

Tax liabilities are subject to self-assessment and a client (and by extension, their professional advisers) needs to ensure their tax assessments are correct. Consideration will need to be given as to the appropriate tax liability and an accountant and/or tax specialist will often need to be involved.

The nature of the receiving party and any compensation they will receive will be a key consideration in determining the tax treatment. Individuals will be liable to pay income tax on income and capital gains tax (CGT) on chargeable gains. Companies will be liable to pay corporation tax on income and chargeable gains.

NO BETTER, NO WORSE (ISH)

The case of *British Transport Commission v Gourley* [1956] AC 185 (*Gourley*) established the principle that, in assessing the appropriate level of compensation, courts must take account of both:

- the tax payable on the award; and
- the tax payable but for the action giving rise to the claim in assessing quantum.

The approach adopted by the court in *Gourley* reflected a simple principle: the compensated party should be put in no better or worse position than had the event giving rise to the claim not occurred. Any award of damages should therefore take account of the relative tax liabilities and adjust the damages upwards or downwards accordingly.

However, subsequent decisions have shown

that the principle in *Gourley* will only be applied where it is practical (and proportionate) to do so. Where the calculation to make an adjustment is too complicated (eg where there are multiple parties all subject to differing levels of taxation), the court will take a pragmatic approach. This means there can be inconsistency in the adjustments made to take account of the tax payable in different cases.

ARE YOU SETTLING FOR THE RIGHT COMPENSATION?

In resolving a dispute you should ensure you are not settling at too low a figure by ensuring that any tax treatment is dealt with.

All litigation solicitors should be familiar with how VAT on legal costs is treated and the circumstances in which you can seek to recover this from the other side. This provides a simple template of factoring tax into settlement discussions. A more complicated issue arises where 'grossing up' has to be factored into any calculations. For example, receiving historic or accelerated compensation in a single tax year, rather than across several, may result in a higher tax liability than would otherwise have been the case absent the cause of action.

HOW ARE YOU STRUCTURING THE SETTLEMENT?

Different types of compensation will be subject to different considerations for tax treatment, with the potential need to increase the compensation sought accordingly. There will be more or less tax efficient approaches to structuring compensation for both the receiving and paying party. Getting that correct is vital in resolving any dispute.

Where compensation relates to a loss of profits from a trade; loss of income from a property business; or breach of contract relating to a business, any such payment is likely to be treated as taxable income. If compensation includes interest, that element could also be taxable as income.

Where part of the compensation relates to employment then income tax will need to be considered, together with relevant exemptions and/or reliefs.

If compensation is paid for physical dam-



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age to an asset, any such payment is likely to be treated on the same basis as a disposal of that asset as a capital gain, although it may not attract the benefit of the same reliefs and exemptions as might be the case on the actual disposal of the asset *Zim Properties v Procter* 58 TC137 (*Zim Properties*).

HMRC's Extra Statutory Concession (ESC D33) has somewhat mitigated the potentially harsh outcomes for claimants receiving compensation or damages for physical damage to an asset arising from *Zim Properties*, in particular:

- A proportion of the (indexed) cost of the underlying asset can be deducted in calculating the capital gain of the right of action;
- Any reliefs or exemptions available on a disposal of the underlying asset will be available on disposal of the right of action; and
- Where the right of action does not relate to an underlying asset for capital gains purposes the first £500,000 of compensation is exempt from CGT. Any amount in excess of that £500,000 limit will be subject to application to HMRC to determine whether an exemption from CGT is available.

VAT ON COMPENSATION

VAT should not apply to compensation payments as long as they are compensation for damage or loss (although see below). However, VAT will be payable where the compensation amounts to a new supply of goods or services. In those circumstances the claimant will need to seek VAT on top of their award, absent which they will have to account for VAT out of their compensation in any event.

Compensation for out-of-court settlements where proceedings have commenced are treated in the same way as payments under

court orders. Where out-of-court settlements are reached before proceedings are commenced, compensation may fall outside the scope of VAT.

One type of compensation that requires particular consideration is where it relates to payment for goods or services from an earlier supply that was subject to VAT. There will be a number of different permutations in such circumstance such that VAT may or may not be payable – with careful consideration and expert input required.

ARE YOU PAYING THE RIGHT COMPENSATION?


Where the compensation paid includes an element of interest, the paying party may need to withhold income tax from the interest payment.

The paying party may also have the ability to make a claim for tax relief on compensation payments where the payment relates exclusively to their trade, and is revenue rather than capital.

If the receiving party will pay less tax on the compensation payment than they would have done on the underlying loss that is being compensated, there may then be scope to seek to reduce the amount paid.

CONCLUSION

Taxation on compensation is not always straightforward. It is always advisable to seek the input of an accountant and/or tax specialist when considering the formulation of any claim and/or settlement.

There are numerous potential pitfalls, but also opportunities to structure a better outcome for both claimants and defendants. Timely, focussed and appropriate advice can ensure the best outcome for clients and lawyers, and hopefully shouldn't prove to be too taxing .



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