TR 2012/D2 - Income tax: assessability of amounts received in respect of legal costs incurred in disputes concerning termination of employment

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This document has been finalised by TR 2012/8.

There is a Compendium for this document: **TR 2012/8EC** .

Generated on: 23 November 2026, 04:39:08 AM

Draft Taxation Ruling

Income tax: assessability of amounts received in respect of legal costs incurred in disputes concerning termination of employment

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What this Ruling is about

1. This Ruling is about whether or not amounts received in respect of legal costs incurred in disputes concerning termination of employment can be included in assessable income either:

- because they form part of an employment termination payment (ETP) within the meaning of section 82-130 of the *Income Tax Assessment Act 1997* (ITAA 1997);[1] or
- as an assessable recoupment under section 20-20, where the legal costs are deductible under section 8-1.

2. This Ruling does not consider the fringe benefits tax (FBT) or goods and services tax (GST) consequences of amounts received in respect of legal costs in disputes concerning termination of employment.

[1] All legislative references are to the ITAA 1997 unless otherwise indicated.

Ruling

3. An amount received in relation to a dispute concerning termination of employment is not an ETP, nor forms part of an ETP, where the amount is capable of being identified as relating specifically to legal costs. This includes a court ordered award of identified and particularised legal costs, or the specified amount in relation to legal costs included in a dissected settlement sum paid in respect of termination of employment.

4. Where legal costs are deductible under section 8-1, a settlement or award in respect of legal costs will be included in the recipient's assessable income as an assessable recoupment under Subdivision 20-A, to the extent that it is not otherwise included in assessable income by another provision of the tax law.

5. If the amount of a settlement or court award received is an undissected lump sum where the component of the receipt that relates to legal costs has not been, and cannot be determined then the whole amount is treated as being received in consequence of termination of employment. This will be the case unless the facts and circumstances surrounding the receipt enables an apportionment of the lump sum payment on a reasonable basis into its constituent elements.

Examples

Example 1

6. *Alice takes legal action seeking compensation for wrongful dismissal and is successful. She is awarded identified and particularised legal costs.*

7. *Alice's award of legal costs, although made in relation to legal action concerning termination of employment, is paid to indemnify her as the successful party for the cost of the litigation and is not paid in consequence of termination of employment. The award of legal costs is not an ETP.*

8. *The legal costs incurred by Alice will not be deductible under section 8-1 because the advantage sought in the legal action is of a capital nature. Alice's award of legal costs is therefore not an assessable recoupment under subsection 20-20(2), nor is it assessable as ordinary income.*

Example 2

9. *Bernard takes legal action to enforce his entitlement to income under an employment contract.*

10. *In resolving the dispute, the Court enforced Bernard's contractual entitlement to the income due under the employment contract and he was also awarded interest and identified and particularised legal costs.*

11. *Bernard's legal costs are incurred in gaining or producing assessable income and the character of the advantage sought in the litigation is of a revenue nature. The legal costs are therefore deductible under section 8-1.*

12. *Bernard's legal costs award is paid to indemnify him as the successful party for the cost of the litigation and is not ordinary income or an ETP. It is an assessable recoupment under subsection 20-20(2) of the ITAA 1997 which provides that an amount received as recoupment of a loss or outgoing is an assessable recoupment if the taxpayer received the amount by way of insurance or indemnity; and the amount is or was deductible under any provision of the Income Tax Assessment Act 1936 (ITAA 1936) or ITAA 1997.*

Example 3

13. *Debbie takes legal action against her former employer for unfair dismissal, seeking damages of $170,000. Debbie incurs $79,000 in legal costs pursuing the claim. The claim is settled within 12 months after termination for the sum of $100,000 in relation to the unfair dismissal claim and $60,000 in relation to the legal costs.*

14. *Debbie receives an amount of $160,000. The settlement is paid in circumstances where Debbie's former employer would not have entered into the Deed if her employment had not ceased. There is a clear connection between the termination of Debbie's employment and the payment made under the deed. The $100,000 was received in consequence' of termination of employment and is therefore an ETP.*

15. *However, the $60,000 although paid in relation to legal action concerning termination of employment is paid to indemnify Debbie for the cost of the litigation. It is not received in consequence of termination of employment and is not an ETP. Nor is the $60,000 an assessable recoupment or assessable as ordinary income.*

16. *The legal costs incurred by Debbie are not deductible under section 8-1 because the advantage sought by the legal action (compensation for loss of employment) is of a capital nature. This is the case, even though the $100,000 recovered through the legal action is assessable as statutory income (an ETP).*

Example 4

17. *Colin commences legal action for unfair dismissal, seeking unliquidated damages. An undissected amount is received in settlement of the claim, including an unspecified amount to cover Colin's legal costs, within 12 months of that termination.*

18. *Colin's lump sum settlement is paid in circumstances where Colin's former employer would not have entered into the Deed if his employment had not ceased. There is a clear connection between the termination of Colin's employment and the payments made under the deed. The lump sum was paid 'in consequence' of termination of employment and is therefore an ETP.*

19. *The legal costs incurred by Colin are not deductible because the advantage sought by the legal action (compensation for loss of employment) is of a capital nature. This is the case, even though the amount recovered through the legal action is assessable as statutory income (an ETP).*

Date of effect

20. When the final Ruling is issued, it is proposed to apply both before and after its date of issue. However, the Ruling will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 75 to 76 of Taxation Ruling TR 2006/10).

Commissioner of Taxation
11 April 2012

Appendix 1 – Explanation

This Appendix is provided as information to help you understand how the Commissioner's preliminary view has been reached. It does not form part of the proposed binding public ruling.

Paid 'in consequence' of termination of employment

21. In order for an award of legal costs to be considered to be an ETP it has to have been paid 'in consequence' of termination of employment.[2]

22. In *Le Grand v. Federal Commissioner of Taxation;*[3] *(Le Grand)*, Justice Goldberg applied the test for determining whether a payment is made in consequence of the termination of employment articulated by Justice Gibbs in *Reseck v. Federal Commissioner of Taxation*[4] *(Reseck)*. For a payment to have been made in consequence of the termination of employment, the payment must follow as an effect or result of the termination of employment. There must be a causal connection between the termination and the payment, even though the termination need not be the dominant cause.

23. Taxation Ruling TR 2003/13 explains the Commissioner's view of the meaning of 'in consequence' in relation to ETPs. In relation to settlement of litigation proceedings, the ruling states at paragraph 31:

> It is clear from the decision in *Le Grand*, that when a payment is made to settle a claim brought by a taxpayer for wrongful dismissal or claims of a similar nature that arise as a result of an employer terminating the employment of the taxpayer, the payment will have a sufficient causal connection with the termination of the taxpayer's employment. The payment will be taken to have been made in consequence of the termination of employment because it would not have been made but for the termination.

The nature of legal costs

24. Legal cost awards are paid to reimburse the expenses incurred in engaging in legal proceedings. Although an award for legal costs may be paid in relation to litigation concerning the termination of employment, an award for legal costs is not paid 'in consequence of termination' of employment.

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[2] See subsection 82-130(1).
[3] 2002 ATC 4907; (2003) 51 ATR 139.
[4] (1975) 133 CLR 45, 75 ATC 4213; (1975) 5 ATR 538.

25. The principles concerning costs orders in curial proceedings were explained in *Precious Metals Australia Limited v. Xstrata Windimurra Pty Limited & Anor:*[5]

> The ordinary rule is of course that costs follow the event in proceedings before the Court. The rule has its rationale by way of a principle of compensation in respect of the successful party to the proceedings recovering the costs incurred in the proceedings.

26. The rationale for the general rule which has a public as well as a private dimension, was identified by McHugh J in *Oshlack v. Richmond River Council:*[6]

> The principle is grounded in reasons of fairness and policy and operates whether the successful party is the plaintiff or the defendant. Costs are not awarded to punish an unsuccessful party. The primary purpose of an award of costs is to indemnify the successful party. If the litigation had not been brought, or defended, by the unsuccessful party the successful party would not have incurred the expense which it did. As between the parties, fairness dictates that the unsuccessful party typically bears the liability for the costs of the unsuccessful litigation.

27. The award of legal costs and the quantum of those costs are generally subject to the discretion of the Court.[7] An award of costs is an action in itself rather than part of the underlying object of any proceeding. The award of particularised legal costs is to ensure that the successful party is not out of pocket for their legal expenses as a result of being required to bring or defend an action.

28. Similarly a settlement sum paid in respect of a claim for legal costs is for the purpose of indemnifying the successful party for the legal expenses incurred in bringing the legal action to the point at which it is settled. A settlement sum in respect of a claim for legal costs is not paid 'in consequence of termination' of employment.

Deductibility of legal costs

29. Legal costs take their quality as an outgoing of capital or revenue nature from the cause or purpose of incurring the expenditure.[8] If the advantage to be gained is of a revenue nature, then the costs incurred in gaining the advantage will also be of a revenue nature.[9]

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[5] [2005] NSWC 147 at paragraph 26.
[6] [1998] HCA 11; (1998) 193 CLR 72 at 97.
[7] See for instance *Oshlack v. Richmond River Council* [1998] HCA 11; (1998) 193 CLR 72 per Gaudron & Gummow JJ at 85; McHugh J at 95.
[8] See *Hallstroms Pty Ltd v. Federal Commissioner of Taxation* (1946) 72 CLR 634; (1946) 3 AITR 436; (1946) 8 ATD 190 per Dixon J at CLR 647.
[9] The character of legal costs is not determined by the success or failure of the legal action.

30. Broadly, section 8-1 allows a deduction for losses and outgoings to the extent to which they are incurred in gaining or producing assessable income except to the extent the outgoings are of a capital, private or domestic nature, or relate to the earning of exempt income or non-assessable non-exempt income.

31. Where the legal costs are incurred to enforce a contractual entitlement which relates to a right to income, even if it is after employment has ceased, the taxpayer will be entitled to a deduction under section 8-1.

32. The question of deductibility of legal costs under section 8-1 to enforce a contractual entitlement to a lump sum payment in lieu of notice was considered in *Romanin v. Commissioner of Taxation.*[10]

33. In *Romanin*, McKerracher J held, at FCA paragraph 52, in terms of the positive limb nexus:

> In my view, the requisite connection exists between the outgoing claimed (legal costs) and the incurrence (sic) of assessable income. On this point, I accept Mr Romanin's submission that he pursued proceedings in the Commission to obtain income that was contractually owed to him and that the costs incurred in doing so are deductible under s 8-1(1) of the ITAA.

34. McKerracher J also held at paragraph 56 of *Romanin*, that the character of the advantage sought was not on capital account, notwithstanding that it was a lump sum payment.

35. A deduction for legal costs by an employee depends on the particular facts of any case. To be deductible the occasion of the expenditure must be found in what is productive in the gaining of assessable income by the employee. If costs are incurred to dispute the receipt of income contractually owed under an employment contract, then the costs are on revenue account and allowable as a deduction.

36. Compensation for loss of employment, such as in an action for wrongful dismissal or loss of office, is a capital receipt (*Scott v. Commissioner of Taxation).*[11] Legal costs incurred in seeking such compensation are not deductible because the nature of the advantage sought is capital. This is so, even if the amount awarded is calculated by reference to unpaid salary or lost income, or is assessable as statutory income.

Assessable recoupment

37. Although a court ordered award or settlement sum identifiable as an amount paid in relation to legal cost is not an ETP, those costs may be an assessable recoupment if the recipient's underlying legal costs were deductible.

[10] [2008] FCA 1532; 2008 ATC 20-055; (2008) 73 ATR 760.
[11] (1935) 35 SR (NSW) 215.

38. The High Court held in *FC of T v. Rowe*[12] that there is no general principle that amounts received by way of reimbursement or compensation for deductible expenses are assessable. The money received must be income according to ordinary concepts or statutory income, to be assessable.

39. If an amount is not ordinary income, the amount may still be included in assessable income by another provision of the tax law (statutory income). Particular types of statutory income are listed in Guide material in section 10-5. Included in that list is Subdivision 20-A which deals with amounts received by way of recoupment for deductible losses or outgoings.

40. Under Subdivision 20-A, certain amounts received by way of insurance, indemnity or other recoupment are assessable income if the amounts are not income under ordinary concepts or otherwise assessable. Amounts included in assessable income under Subdivision 20-A are statutory income within the meaning of section 6-10.

41. Subsection 20-20(2) of the ITAA 1997 provides that an amount received as recoupment of a loss or outgoing is an assessable recoupment if the taxpayer received the amount by way of insurance or indemnity; and the amount of the loss or outgoing is or was deductible under any provision of the ITAA 1997 or ITAA 1936.

Indemnity

42. For an award of legal costs to be an assessable recoupment it must be a recoupment. Recoupment as defined in paragraph 20-25(1)(a) includes an indemnity in respect of the loss or outgoing.

43. In the High Court decision of *Cachia v. Hanes*[13] the court considered an appeal on the disallowance of the appellant's claim for compensation for the loss of his time spent in the preparation and conduct of his case and for out of pocket expenses, being travelling expenses associated with the preparation and conduct of his case. In the preliminary observations of the law the Full Court stated at paragraph 11:

> …It has not been doubted since 1278, when the Statute of Gloucester ((4) 6 Edw.I c.1.) introduced the notion of costs to the common law, that costs are awarded by way of indemnity (or, more accurately, partial indemnity) for professional legal costs actually incurred in the conduct of litigation.

[12] (1997) 187 CLR 266; (1997) 35 ATR 432; 97 ATC 4317.
[13] [1994] HCA 14; (1994) 179 CLR 403; (1994) 1209 ALR 385; (1994) 68 ALJR 374 (1 April 1995).

44. Particularised legal costs are awarded to the successful party by way of indemnity; they are awarded to indemnify the successful party for the cost of the litigation. They are an assessable recoupment under subsection 20-20(2) of the ITAA 1997 if the amount recouped is or was deductible under any provision of the ITAA 1997 or ITAA 1936.

45. Similarly, if an amount is recouped by way of settlement of a claim for legal costs, it will be an assessable recoupment under subsection 20-20(2) where the purpose of the settlement is to indemnify the recipient for professional legal costs actually incurred in the conduct of litigation,[14] where the legal costs were deductible.

Legal costs where a settlement of all claims in respect of termination of employment leads to a lump sum award

46. Where the payment of a lump sum award is in respect of various heads of claim that are accepted under a settlement which treats them as a single, undissected amount, then that amount must be considered as a whole.[15]

47. The High Court in *McLaurin v. FC of T*[16] *(McLaurin),* stated:[17]

> It is true that in a proper case a single payment or receipt of a mixed nature may be apportioned amongst the several heads to which it relates and an income or non-income nature attributed to portions of it accordingly. …But while it may be appropriate to follow such a course where the payment or receipt is in settlement of distinct claims of which some at least are liquidated … or are otherwise ascertainable by calculation … it cannot be appropriate where the payment or receipt 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, undissected amount of damages. In such a case the amount must be considered as a whole

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[14] A settlement amount received by way of indemnity for legal expenses could not exceed the professional legal costs actually incurred in the conduct of the litigation. Simply labelling an amount as legal costs does not make it legal costs. In *FC of T v. BHP* (2000) 179 ALR 593 at 603; (2000) 45 ATR 507; [2000] ATC 4659 at 4668 Hill J said:

> 'The true position is that the label that a party uses to characterise payment, in the present case the word 'interest', will not be determinative, although it may have some relevance…(w)hat that relevance may be will depend on the particular circumstances of the case…So, it may be said that an amount payable does not become interest, if the parties chose to adopt that word, if in law it is not.'

[15] The Commissioner's view on the circumstances in which a lump sum settlement sum may be apportioned for the purposes of former s.25(1) of the ITAA 1936 is set out in Taxation Determination TD 93/58 *Income tax: under what circumstances is the receipt of a lump sum compensation/settlement payment assessable?* At sub-paragraph 1(b) it is stated that an expressed or implied agreement between the parties as to apportionment may lead to an amount being identifiable and quantifiable.

[16] (1961) 104 CLR. 381; (1961) 12 ATD 273; (1961) 8 AITR 180.

[17] (1961) 104 CLR 381 at 391.

48. A court ordered award identifying and particularising legal costs is not an ETP, nor forms part of an ETP.

49. On the other hand, a settlement lump sum payment, made in consequence of termination, in respect of a claim for an unliquidated sum is not prevented from being an ETP by the fact that it includes a component for legal costs that has not been and cannot be quantified, The lump sum will be considered as a whole and be an ETP, unless the facts and circumstances surrounding the receipt enables an apportionment of the lump sum payment on a reasonable basis into its constituent elements.[18]

[18] See for instance the examples given at paragraphs 190 – 209 of Taxation Ruling TR 95/35 *Income tax: capital gains: treatment of compensation receipts*.

Appendix 2 – Your comments

50. You are invited to comment on this draft Ruling, including the proposed date of effect. Please forward your comments to the contact officer by the due date.

51. A compendium of comments is prepared for the consideration of the relevant Rulings Panel or relevant tax officers. An edited version (names and identifying information removed) of the compendium of comments will also be prepared to:

- provide responses to persons providing comments; and
- be published on the ATO website at www.ato.gov.au.

Please advise if you do not want your comments included in the edited version of the compendium.

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Appendix 3 – Detailed contents list

52. The following is a detailed contents list for this Ruling:

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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2003/13; TR 2006/10; TR 95/35 TD 93/58

Subject references:

Assessable recoupments
Employment termination
Legal Expenses

Legislative references:

- ITAA 1936
- ITAA 1936 former 25(1)
- ITAA 1997 6-10
- ITAA 1997 8-1
- ITAA 1997 10-5
- ITAA 1997 20-A
- ITAA 1997 20-20
- ITAA 1997 20-20(2)
- ITAA 1997 20-25(1)(a)
- ITAA 1997 82-130(1)

Case references:

- Cachia v. Hanes [1994] HCA 14; (1994) 179 CLR 403; (1994) 1209 ALR 385; (1994) 68 ALJR 374
- FC of T v. BHP (2000) 179 ALR 593; (2000) 45 ATR 507; [2000] ATC 4659
- FC of T v. Rowe (1997) 187 CLR 266; (1997) 35 ATR 432; 97 ATC 4317
- Hallstroms Pty Ltd v. Federal Commissioner of Taxation (1946) 72 CLR 634; (1946) 3 AITR 436; (1946) 8 ATD 190
- Le Gran v. Federal Commissioner of Taxation (2003) 51 ATR 139; 2002 ATC 4907
- McLaurin v. FC of T (1961) 104 CLR 381; (1961) 12 ATD 273; (1961) 8 AITR 180
- Oshlack v. Richmond River Council [1998] HCA 11; (1998) 193 CLR 72
- Precious Metals Australia Limited v. Xstrata Windimurra Pty Limited & Anor [2005] NSWC 147
- Reseck v. Federal Commissioner of Taxation (1975) 133 CLR 45, 75 ATC 4213; (1975) 5 ATR 538
- Romanin v. Commissioner of Taxation [2008] FCA 1532; 2008 ATC 20-055; (2008) 73 ATR 760
- Scott v. Commissioner of Taxation (1935) 35 SR (NSW) 215

ATO references

NO:	1-3HUIBQG
ISSN:	1039-0731
ATOlaw topic:	Income Tax ~~ Assessable income ~~ recoupments