Collateral Damage: GST and Income Taxation of Settlements and Release Payments

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As parties emerge from the throes of "litigation", often battered, bruised and bloodied by seemingly endless legal manoeuvring, the tax consequences of having proceeded to resolve a legal dispute in a particular fashion can be overlooked. Yet, regardless of whether parties are bound by a judicial decision or manage to fashion an out of court settlement, it is critical that they be aware of the potential tax implications.

A number of comprehensive papers have been written on the Canadian income tax treatment of damages and settlement payments.[1] Several articles have also focused upon the application of the federal Goods and Services Tax and the Harmonized Sales Tax (collectively, the "GST"), levied pursuant to Part IX of the *Excise Tax Act* (Canada) (the "ETA"), to damages and settlement amounts paid by litigants.[2]

Nevertheless, much uncertainty continues to cloud the appropriate GST and income tax treatment of the types of payments that frequently arise in connection with legal proceedings. For instance, while the Canada Customs and Revenue Agency (the "CCRA") has released a number of administrative statements discussing the GST treatment of payments made in respect of "damages" (as referenced below), such pronouncements have neglected to discuss how GST will apply to payments made in exchange for another party's agreement to *surrender* certain rights following the resolution of a judicial or administrative matter ("Surrender Amounts"). Although most Surrender Amounts flow directly from the resolution of a legal dispute, the reason for their payment differs fundamentally from that associated with damages or damages settlement payments traditionally made as compensation for a past breach of contract or tortious act.

To illustrate the gaps in the CCRA's prevailing interpretive position on the taxation of Surrender Amounts, we will focus primarily on the GST considerations faced by the payor and payee of Surrender Amounts in one factual scenario. We will also briefly survey some of the income tax considerations that may be faced by such parties.

Illustrative Example

In February, a local restaurant owner (the "Owner") applies to the Ontario Alcohol and Gaming Commission for a license to sell liquor on an outdoor patio located in front of his restaurant. Upon receiving notice of the application, neighbouring businesses (the "Neighbours") voice opposition to the application and prepare submissions in support of their contention that the application should be denied. Each of the Neighbours owns the building in which its business is located and fears that the introduction of outdoor liquor service may degrade the character of the community and adversely affect its business.

In response to such opposition, the Owner offers to pay each of the Neighbours $5,000 in exchange for their agreement not to formally oppose his application and to cease conducting outdoor sales activities on their premises (the "Payments").[3] The agreement between the parties is reduced to writing and both the Owner and the Neighbours sign a self-described "Liquor Settlement Agreement". Just prior to the end of the year, the Owner provides each of the Neighbours with a cheque for $5,000 and the Neighbours withdraw their formal objections and cease their outdoor sales activities.

The Owner and the Neighbours are registered for the GST and are engaged exclusively in commercial activities for GST purposes.

The GST Treatment of "Damages" Payments: An Overview

The CCRA has acknowledged that, to the extent that payments made in respect of "damages"[4] are not made as consideration for a supply of property or services, GST is not exigible unless section 182 of the

ETA applies.[5] Section 182 of the ETA applies where, as a consequence of the breach, modification or termination of an agreement for the making of a taxable supply by a registrant, an amount is paid or forfeited to the registrant otherwise than as consideration for the supply, or a debt or other obligation of the registrant is reduced or extinguished without payment on account of the debt or obligation.

In the example above, the Surrender Amounts paid by the Owner do not arise as a consequence of the breach, modification or termination of an agreement for the making of a taxable supply by the Owner, so section 182 of the ETA is inapplicable.

The GST Treatment of "Surrender Amounts"

In cases where section 182 of the ETA does not apply, the CCRA has taken the general position that, where a person has received payments *solely* as compensation for a loss or deprivation suffered at the hands of another, GST is not applicable.[6] In essence, the CCRA contends that such payments simply make the person "whole" and that the payee does not make any supply of property or services for such payments.[7] Furthermore, the CCRA has indicated that a general release from a civil cause of action provided in exchange for a compensatory settlement payment does not, in and of itself, constitute a taxable supply.[8]

While the position of the CCRA on the GST treatment of "conventional" damage payments is quite straightforward, the GST treatment of Surrender Amounts is far less certain. For instance, where a party requests a positive declaration from an administrative body and thereafter makes payments to other parties who are disputing the request in exchange for their pledge not to challenge the pending request, are such payments made in respect of conventional damages (so no GST applies) or the acquisition or supply of some type of "right" (to which GST may apply)?

The ETA is broad enough that GST could apply to the payment of Surrender Amounts. Section 165 of the ETA requires every recipient of a "taxable supply", other than a zero-rated supply, made in Canada to pay GST. The phrase "taxable supply" is defined in section 123(1) of the ETA as a supply that is made in the course of a "commercial activity". For the purposes of our analysis, the definition of a "commercial activity" found in section 123(1) of the ETA includes a business or an adventure or concern in the nature of trade, except to the extent that such activities involve the making of exempt supplies. Thus, to the extent that the granting of a right or an agreement to refrain from engaging in some form of conduct may be said to be a "supply" made in the course of a business or an adventure or concern in the nature of trade, GST may rightly be applicable.

Section 123(1) of the ETA defines a "supply" expansively to generally include the provision of any property or service and defines "property" in an extremely broad fashion as:

> any property, whether real or personal, movable or immovable, tangible or intangible, corporeal or incorporeal, and includes *a right or interest of any kind*, a share and a chose in action, but does not include money. [Emphasis added.]

The GST Treatment of Surrender Amounts: The "Liquor Settlement Agreement"

In reviewing the example presented above, it is helpful to divide the obligations assumed by the Neighbours under the Liquor Settlement Agreement into two distinct categories. First, the Neighbours receive the Payments, in part, for agreeing to both: (i) cease their outdoor commercial operations; and (ii) restrict the terms upon which they may sell their businesses in the future (the "Restrictive Covenants"). Second, the Neighbours receive the Payments, in part, for withdrawing their objections to the liquor licensing application brought forward by the Owner (the "Objection Withdrawal").

Category #1 — The Restrictive Covenants

With respect to the portion of the Payments received by the Neighbours in exchange for agreeing to the Restrictive Covenants, such payments arguably constitute consideration for the supply of "property". Specifically, the Neighbours supply "rights" to the Owner that allow the Owner to enforce the Neighbours' obligations:

(i) to immediately discontinue their outdoor retail operations; and

(ii) to only sell their businesses subject to the restriction that outdoor sales activities not be undertaken in the future.

The Owner acquires "rights" of value because the absence of the noise and clutter created by neighbouring outdoor sales activities will enhance the dining experience enjoyed by the Owner's customers and, thereby, increase the traffic, profitability and value of the Owner's restaurant.

Category #2 — The Objection Withdrawal

The Neighbours' agreement to withdraw their objections to the Owner's liquor licensing application is tantamount to granting the Owner the "right" to proceed, without further delay, with his desire to obtain authorization to serve alcoholic beverages to patrons on his outdoor patio, which again potentially falls within the broad definition of a supply of "property" contained in the ETA.

By way of analogy, one could compare the rights described above to the rights created by a non-competition covenant. In both instances, one party agrees to refrain from engaging in a specified form of conduct in exchange for valuable consideration from another party. Recent judgments rendered by the Federal Court of Appeal and the Tax Court of Canada in *Fortino v. The Queen*[9] and *Manrell v. The Queen*[10] support the proposition that the granting of a non-compete covenant is a disposition of rights within the context of the *Income Tax Act* (Canada) (the "ITA"). The CCRA has similarly expressed the view that the provision of a non-compete pledge can also constitute a taxable supply for the purposes of the GST.[11]

In addition, it may be difficult for the Neighbours to argue that the supplies that they make under the Liquor Settlement Agreement are not "made in the course of a commercial activity". Section 141.1(3)(a) of the ETA states that "to the extent that a person does anything ... in connection with the ... disposition or termination of a commercial activity of the person, the person shall be deemed to have done that thing in the course of commercial activities of the person". Since the Neighbours are terminating or disposing of a portion of their commercial activities and/or their rights to conduct such activities (*i.e.*, their outdoor sales activities), it would be difficult for the Neighbours to assert that the Payments were not made "in connection with" the termination of a commercial activity and, therefore, are not subject to GST. Furthermore, no specific GST exemption or zero-rating relief would apply to any supply of property (*i.e.*, rights) made by the Neighbours to the Owner.

To the extent that the Neighbours would be considered to make taxable supplies of property (*i.e.*, rights) in the course of their commercial activities to the Owner, they would make those taxable supplies in Canada.[12] The Neighbours would be required to charge, collect and remit GST in respect of the taxable supplies made in Canada to the Owner. The Neighbours would want to insist on the Surrender Amounts being exclusive or net of any GST so that GST of $350 would be payable in addition to the $5,000 Surrender Amounts. Subject to obtaining the prescribed documentation from the Neighbours, the Owner would recover the $350 GST payments by claiming input tax credits on his GST return.

Income Tax Implications of the Liquor Settlement Agreement

Although this article focuses primarily on the GST treatment of the Surrender Amounts, tax counsel should also advise their clients of the Canadian income tax considerations that may arise under the circumstances described above.

Unfortunately, the ambiguities inherent in the ITA, coupled with a series of recent, seemingly conflicting, judicial decisions, suggest that the appropriate income tax treatment of the Payments is far from certain.[13] In fact, there appear to be three possible ways in which the Payments could be characterized for Canadian federal income tax purposes.

Possibility #1 — Regular Capital Gains Treatment

On balance, the current jurisprudence would suggest that the rights that the Neighbours surrendered under the Liquor Settlement Agreement would represent the sale of some form of capital property, which could give rise to a capital gain. Under the ITA, 50% of any such capital gain would be included in income.

Possibility #2 — Non-Taxable Receipt Treatment

On the other hand, on a conceptual basis, any gain that the Neighbours may be said to have enjoyed as a result of receiving the Payments from the Owner could arguably be characterized as compensation for the impairment of the Neighbours' real property holdings at the site in question, on the basis that no property was actually "disposed of" for the purposes of the ITA. Consistent with *Ipsco*, there is no provision in the ITA that would require the Neighbours to reduce the adjusted cost base of their real property holdings for the purposes of the ITA. Thus, the Payments would effectively be treated as non-taxable receipts (*i.e.*, "nothings") for income tax purposes.

Possibility #3 — Eligible Capital Property Treatment

The rights that the Neighbours surrendered under the Liquor Settlement Agreement could alternatively be said to constitute "eligible capital property" pursuant to section 14 of the ITA. Under the terms of the ITA, a prescribed percentage of all "eligible capital expenditures" (*i.e.*, purchases of eligible capital property) made by a taxpayer are placed in a pool and a taxpayer is permitted to deduct 7% of the adjusted value of the pool each year in a manner that is comparable to a standard depreciation deduction. Yet, each time a taxpayer sells a piece of eligible capital property, a prescribed proportion of the amount received for such property is deducted from the value of the pool. To the extent that the value of the pool becomes negative in any particular year, a prescribed proportion of the negative amount must generally be included in the taxpayer's income.

In the absence of other cumulative eligible capital property held by the Neighbours that may serve to offset any immediate income tax effects of the Payments, the net result of treating the Payments as having been made in respect of eligible capital property would, generally speaking, be the inclusion of approximately 50% of the value of the Payments minus any associated expenses in the income of each of the respective Neighbours.[14]

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One deceptive part of the conceptual analysis canvassed above is that dispositions of "property" normally result in the recipient or transferee (*i.e.*, the beneficiary of the disposition) acquiring the very same property that the transferor owned. However, in the case of a non-compete covenant or a disposition by which a transferor surrenders certain rights, the transferee clearly benefits from, and pays money for, certain rights, yet does not acquire the specific rights in kind that the transferor previously enjoyed. Rather, the transferee acquires an enforceable right to prevent the transferor from exercising the rights that the transferor surrendered. Nevertheless, despite such distinctions, the rights acquired in exchange for such payments arguably constitute "property", thereby raising a host of GST and income tax considerations.

As demonstrated above, the GST and federal income tax implications of making the Payments are potentially wide-ranging. When negotiating and documenting what most laypersons would refer to as "settlement agreements", due attention must be focused upon the potential incidence of GST, the characterization of payments for income tax purposes and the allocation of the resulting tax burden among the parties to the agreement. Ultimately, failure to devote sufficient time and effort to fully examining the GST and income tax treatment of any exchange of payments may ultimately expose "litigants" to significant and unexpected GST and income tax liabilities, while exposing advisors to both the consternation of their clients and potential claims of negligence.

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[1] See, for example, Joel A. Weinstein, "Damages, Fines, and Penalties: An Update", *Report of Proceedings of the Fifty-Second Tax Conference*, 2000 Tax Conference (Toronto: Canadian Tax Foundation, 2001), 7:1-29; and Sharon J. Hugo and Alan Rautenberg, "Damages and Settlements: Taxation of the Recipient" (1993), Vol. 41, No. 1 *Canadian Tax Journal*, 1-37.

[2] See, for example, Blair Nixon and Craig McDougall, "Damages — A Symposium '95 Update", *1995 Commodity Tax Symposium* (Ottawa: Canadian Institute of Chartered Accountants, 1995), vol. 1, tab 6; and Dennis Wyslobicky, "Practical Tips and Traps Under the GST and PST Legislation: Emerging GST and PST Issues", *1999 Ontario Tax Conference* (Toronto: Canadian Tax Foundation, 1999), 2:1-42.

[3] The Neighbours also agree to only sell their premises, and/or the businesses carried on at their premises, to parties that will not conduct outdoor sales activities.
[4] That is, payments made by one party to compensate another for damage or injury caused by the payor's malfeasance or breach of contract.
[5] See, for example, CCRA, Policy Number P-218, "Tax Status of Damage Payments Not Within Section 182 of the *Excise Tax Act*" (25 May 1998); and CCRA, GST/HST Interpretation, #32195 "GST/HST Information Concerning Compensation Payments" (31 July 2000).
[6] See, for example, CCRA, GST Interpretation, #96 GAPR 038, "Damage Claims" (16 March 1996); CCRA, GST/HST Interpretation, document number 11585-1 [E], "Damage Settlement Payments" (4 December 1998); and Policy P-218, *supra* note 5.
[7] See, for example, CCRA, GST/HST Interpretation, #HQR0000217, "Damage Claims" (29 June 1998); and Policy P-218, *supra* note 5.
[8] Policy P-218, *supra* note 5.
[9] [2000] 1 CTC 349 (FCA) [hereinafter *Fortino*].
[10] [2002] 1 CTC 2543 (TCC) [hereinafter *Manrell*].
[11] See, for example, CCRA, GST/HST Interpretation, #7940, "Non-Competition Payment" (27 March 2000); and CCRA, GST/HST Interpretation, #8293, "Non-Competition Payment" (27 March 2000).
[12] Section 142(1)(c) of the ETA.
[13] For instance, in *Manrell*, the Tax Court of Canada affirmed that the term "property" includes "the promise to do or not to do certain things". Although recent decisions rendered by the Federal Court of Appeal and the Tax Court would initially appear to be inconsistent with the judicial holding in *Manrell* (as more fully discussed below), the unique fact patterns and pleadings associated with each of the former cases provide a firm basis upon which the judgments can be distinguished. In turn, although we understand that the judgment of the Tax Court in *Manrell* is currently under appeal, even a cursory examination of the prevailing jurisprudence raises enough uncertainty to suggest that payments made in respect of the granting of certain rights, or the undertaking of corresponding obligations, may constitute the disposition of property for the purposes of the ITA.
As described above, in *Fortino* and *Ipsco Inc. v. The Queen*, 2002 DTC 1421 (TCC) [hereinafter *Ipsco*], the Federal Court of Appeal and the Tax Court respectively rendered judgments that, on their surface, would appear to contradict the judicial holding in *Manrell*. However, each of the two judgments can potentially be distinguished on the basis of the unique fact patterns and pleadings that were under consideration in each case. Specifically, in *Fortino*, the Crown failed to assert that the payments at issue could be on account of capital and, in *Ipsco* the disposition of the case rested heavily upon the unique wording of the capital cost allowance provisions of the ITA.
[14] However, it is worthy of note that, by virtue of the election available under section 14(1.01) of the ITA, planning opportunities may exist where a taxpayer has unutilized tax losses from past years and is set to dispose of eligible capital property.