

TECHNICAL DECISION SUMMARY > PRIVATE RULING

WHAKARĀPOPOTO WHAKATAU HANGARAU > WHAKATAUNGA
TŪMATAITI

Compensation – capital or revenue nature

Decision date | Rā o te Whakatau: 26 February 2024

Issue date | Rā Tuku: 7 June 2024

TDS 24/12

DISCLAIMER | Kupu Whakatūpato

This document is a summary of the original technical decision so it may not contain all the facts or assumptions relevant to that decision.

This document is made available for **information only** and is not advice, guidance or a “Commissioner’s official opinion” (as defined in s 3(1) of the Tax Administration Act 1994).

You cannot rely on this document as setting out the Commissioner’s position more generally or in relation to your own circumstances or tax affairs. It is not binding and provides you with no protection (including from underpaid tax, penalty or interest).

For more information refer to the [Technical decision summaries guidelines](#).

Subjects | Kaupapa

Income tax: business income, capital nature, compensation, income under ordinary concepts, lump-sum payment, settlement payment

Taxation laws | Ture tāke

All legislative references are to the Income Tax Act 2007.

Facts | Meka

1. Company A and Company B are both New Zealand incorporated and tax resident companies. An unrelated third party's unlawful action caused damage to the companies' intellectual property (IP).
2. The companies claimed compensation for the damaged IP. Following an independent review, an appropriate amount was recommended. The companies each received a lump sum Settlement Payment equal to the recommended amount.
3. The IP was represented in the contractual rights held under licences to commercialise certain products. The Settlement Payment was made for the damage to these rights. The IP was not destroyed but suffered significant and permanent damage.
4. The amount of the Settlement Payment was based on the value of the licences. This was determined on discounted future cash flows from income streams over a number of years that were expected to arise from the licences had the damage not been done.

Issues | Take

5. The main issues considered in this ruling were whether the Settlement Payment was income from:
 - a business under s CB 1(1) or under ordinary concepts under s CA 1(2); or
 - compensation for interruption or impairment of business activities under s CG 5B; or
 - compensation for trading stock under s CG 6.

Decisions | Whakataau

6. The Tax Counsel Office (TCO) decided that the Settlement Payment was not income under ss CB 1(1), CA 1(2), CG 5B or CG 6. It was an amount of a capital nature.

Reasons for decisions | Pūnga o ngā whakataau

Issue 1 | Take tuatahi: Did ss CB 1 or CA 1(2) apply?

7. An amount is income of a person under s CB 1 if it is from a business and is not an amount of a capital nature.
8. An amount is income under s CA 1(2) if it is the person's income under ordinary concepts. An amount that is capital in nature will not constitute income under ordinary concepts.¹
9. To determine whether a business receipt is capital or revenue in nature, the important consideration is the character of the receipt in the hands of the recipient. A close examination of the facts of the particular case and the character of the payment is required and, in particular, considering:
 - The scope of the recipient's business;²
 - The periodicity, recurrence or regularity of the receipts;³
 - The consideration provided for the receipts;⁴ and
 - The purpose and reason for which the money is received.⁵

¹ *Case S86* (1996) 17 NZTC 7,538.

² *CIR v City Motor Service Ltd* [1969] NZLR 1,010; *FCT v Myer Emporium* 87 ATC 4363; *AA Finance Ltd v CIR* (1994) 16 NZTC 11,383.

³ *Reid v CIR* (1985) 7 NZTC 5,176; *MIM Holdings Ltd v FCT* 97 ATC 4,420; *Scott v FCT* (1966) 117 CLR 514; *FCT v Hyteco Hiring Pty Limited* 92 ATC 4,694; *Birkdale Service Station Ltd v CIR* [2001] 1 NZLR 293.

⁴ *MIM Holdings; The Federal Coke Company Ltd v FCT* 77 ATC 4255; *Birkdale Service Station; GP International Pipecoaters Pty Ltd v FCT* 90 ATC 4,413.

⁵ *McLaurin v FCT* (1961) 104 CLR 381; *Case V8* (2001) 20 NZTC 10,092; *Reid; The Federal Coke Company; Riches v Westminster Bank Ltd* [1947] AC 390; *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271; *GP International Pipecoaters; City Motor Service*.

Compensation payments

10. With reference to a compensation payment specifically, the main question determining whether it is capital or revenue in nature is what the compensation was paid for,⁶ and - related to this - the character of the payment in the hands of the recipient.⁷ Legal documents help determine this.⁸
11. Characterising a compensation payment requires determining whether the function of the payment was to compensate for an asset or for the revenue that would have been derived from the asset.⁹
12. The following elements generally indicate that a compensation payment is revenue in nature:
 - Compensation payments that are received to “fill the hole of” (ie, replace) lost business profits or revenue that would have been received.¹⁰
 - The sum resulted from an ordinary incident of carrying on business.¹¹
 - Mere restriction of trading opportunities, “temporary setback”.¹²
 - Consequential damage to capital asset resulting in loss of use.¹³
 - Partial injury as opposed to total loss.¹⁴
13. These factors point towards the sum being capital in nature:
 - Total loss of an asset.¹⁵
 - Sums received for what is not in the ordinary run of business.¹⁶

⁶ *London and Thames Haven Oil Wharves Ltd v Attwooll* [1967] 2 All ER 124.

⁷ *Sydney Refractive Surgery Centre Pty Ltd v FC of T* 2008 ATC ¶20-081.

⁸ *Sayer v CIR* (1999) 19 NZTC 15, 249; *Case V8*.

⁹ *Egmont Cooperative Dairies Ltd (in liq) v CIR* (1996) 17 NZTC 12,536.

¹⁰ *Burmah Steam Ship Co Ltd v CIR* (1930) 16 TC 67; *Omihī Lime Co Lt v CIR* [1964] NZLR 731; *Case S104* (1996) 17 NZTC 7,662; *Heavy Minerals Pty Ltd v FCT* (1966) 115 CLR 512.

¹¹ *Higgs v Olivier* [1952] Ch 311.

¹² *Burmah Steam Ship; Case V8*.

¹³ *London and Thames Haven Oil Wharves*.

¹⁴ *London and Thames Haven Oil Wharves*.

¹⁵ *London and Thames Haven Oil Wharves*.

¹⁶ *Cox v C of IR* (1992) 14 NZTC 9,164.

- Sums received for destruction, deprivation or sterilisation of a capital asset.¹⁷
 - Sums received for cancellation of arrangements that still had a long time to run.¹⁸
 - Sums received for damage to structural aspects of the business (agreements can be part of the structure).¹⁹
 - Damages for an injury to business reputation can be compensation for lost earning capacity resulting from damage to a capital asset.²⁰
14. For the compensation payment to be on capital account, it is not necessary that there is a complete destruction of the asset so that it produces no revenue.²¹ Significant damage to the asset that affects its earning capacity will also suffice.
15. In terms of the measure (quantum) adopted to arrive at the compensation amount, the courts have said:
- The method of measuring depends on the circumstances.²²
 - The measure by which the amount of damages or compensation is ascertainable is no criterion of the capital or revenue character of the sum – some said there is no relation at all.²³
 - The mere use of the anticipated profits as a measure did not make the sum paid revenue in nature.²⁴
 - Sometimes, measuring the sum by lost revenue is the only and the best way to measure it.²⁵

TCO's conclusion

16. TCO concluded that the Settlement Payment was of a capital, not revenue nature, for the following reasons:

¹⁷ *Burmah Steam Ship; Glenboig Union Fireclay Co Ltd v IR Commrs* (1922) 12 TC 427; 1922 SC 112; *Case L94* (1989) 11 NZTC 1,542.

¹⁸ *Van den Berghs Ltd v Clark* [1935] AC 431; *Barr, Crombie & Co Ltd v IR Commrs* (1945) 26 TC 406.

¹⁹ *Van den Berghs; Barr, Crombie & Co.*

²⁰ *Sydney Refractive Surgery.*

²¹ *Van den Berghs; Barr, Crombie & Co.*

²² *Sydney Refractive Surgery.*

²³ *Glenboig Union Fireclay; Burmah Steam Ship; Sydney Refractive Surgery.*

²⁴ *Barr, Crombie & Co.*

²⁵ *Sydney Refractive Surgery.*

- On the documents provided, TCO ascertained that the companies' business structure was complex with many elements present, licencing being one and an essential part of it. The disruption of one stage of the production process had flow-on effects on subsequent stages.
- The companies received the Settlement Payment for the damage to their IP rights. This is expressly what the companies and the third party agreed to in the key document.
- The damage to the IP rights was measured by reference to lost future profits, with discounts to adjust for the uncertainties of commercial life. However, TCO concluded that the fact the Settlement Payment was calculated on lost future revenues did not determine the nature of the Settlement Payment.
- The IP rights were part of the "structure" of the companies' business. Without the IP rights, the business could not exist, or the structure would be very different. The IP rights themselves were a capital asset from which the companies expected to receive income.
- The companies' IP rights had been permanently damaged, and that the damage could be classified as significant or substantial. This was because the third-party actions which had caused the damage and for which the Settlement Payment was received had significantly reduced the companies' ability to participate in the market in which they would otherwise have been able to participate. TCO considered that the companies had effectively lost earning capacity from the only asset they held.
- The nature of the compensatory payment was one-off rather than regular or recurrent.

17. Therefore, TCO concluded that the Settlement Payment was not income under ordinary concepts under s CA 1(2) and was not business income under s CB 1(1).

Issue 2 | Take tuarua: Did s CG 5B apply?

18. An amount that results from an event and is compensation for interruption or impairment of business activities will be income under s CG 5B to the extent that it is attributable to income that the person would have derived had it not been for the event.²⁶
19. TCO concluded that the Settlement Payment was not income under s CG 5B as it was not for an interruption or impairment of the companies' business activities. Rather, it

²⁶ Section CG 5B also applies to receipts from insurance, and indemnity.

was to compensate for the damage to the IP. It was also not attributable to income but was capital in nature.

Issue 3 | Take tuatoru: Did s CG 6 apply?

20. Section CG 6 applies to the payment of compensation for loss, destruction or damage to trading stock or anything acquired, manufactured or produced ancillary to a business of manufacturing or producing goods for sale or exchange.²⁷ The part of the payment attributable to the asset is income if the person is allowed a deduction for the cost of the asset, and the deduction is not for an amount of depreciation loss.
21. "Trading stock" in s YA 1 includes anything "produced" or manufactured; anything acquired for the purposes of manufacture or disposal; and anything for which expenditure is incurred and which would be trading stock if possession were taken.
22. TCO decided that the companies did not acquire their IP rights for the purposes of manufacture or disposal (ie, the IP rights were not trading stock). TCO also decided the companies were not in the business of manufacturing or producing goods for sale or exchange. For these reasons, TCO concluded that s CG 6 did not apply.

²⁷ Section GC 6 also applies to receipts from insurance, and indemnity.