

A Note on the Taxation of Section 94 "Interest" "Fruit of the Tree or Just a Taller Tree"?

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"The fundamental relation of 'capital' to 'income' has been much discussed by economists, the former being likened to the tree or the land, the latter to the fruit or the crop: the former depicted as a reservoir supplied from springs, the latter as the outlet stream, to be measured by its flow during a period of time." Per Pitney J in *Elsner v Macomber* (1919) 252 US 189 at 206-7.

The decision of the Federal Court in *Whitaker v Commissioner of Taxation* on 21 August 1996, [1996] 2 ATC 4823 (appeal pending) is important for lawyers practising in the personal injury field. Briefly, interest under section 94 of the *Supreme Court Act* 1970 (NSW) was held to be assessable income under section 25(1) of the *Income Tax Assessment Act* 1936 (the Act) and part of legal costs were held to be an outgoing incurred in gaining assessable income and hence an allowable deduction under section 51(1) of the Act. Interest imposed under section 95 of the *Supreme Court Act* 1970 (NSW) was also affirmed as assessable income.

The amount of the so-called section 94 "interest" was \$65,514 in a judgment debt of \$808,564 arising from a verdict of negligence against a surgeon. The \$65,514 "interest" amount was agreed between the parties to the common law action and was the subject of a consent order. There was no evidence of the rate of interest, the sum to bear interest or the period for which interest accrued.

Campbell J in the Supreme Court of New South Wales in *Whitaker v Rogers* (1990) Aust Torts Reports 81-062 at p.68,337 summarised the heads of damages as follows:

A. Loss of economic capacity for the past	\$ 78,074
B. Loss of economic capacity for the future	104,059
C. Past medical expenses	4,203
D. Future medical expenses	38,464
E. Care	346,768
F. Home renovation	30,000
G. Activity equipment	15,545
H. Transport costs	5,937
I. General Damages (\$50,000 for the past)	<u>120,000</u>
Total	\$ <u>743,050</u>

The general form of judgment set out in Form 50 in Schedule F of the *Supreme Court Rules* provides: "that the defendant pay to the plaintiff \$ _____ damages and \$ _____ costs". No reference is made to section 94 or other rights of action as all rights merge in the judgment debt.

The amount of section 94 interest "by way of damages is an integer to be included in the sum for which judgment is given".

In the course of his reasons in *Whitaker's* case Hill J referred to the decision of the Court of Appeal in *Pheeny v Doolan* [1977] 1 NSWLR 601 and cited the following passages: per Moffit P at p. 604 supra:

"... (the interest) was not designed to compensate a plaintiff for loss arising out of the cause of action but to provide compensation when a sum of money has been outstanding for a period of time. This follows because of the nature of the payment provided. It is 'interest' which may be awarded on the whole or part of the money recovered by the judgment. It presupposes a determination at some time of the amount of money to which the plaintiff is entitled by reason of his cause of action against the defendant."

Later, at p.605, his Honour said:

"While the essential nature of the award is to compensate a plaintiff by reason of delay in payment of moneys there is no entitlement to interest. The Court must be persuaded that it is just, between the plaintiff and the defendant, to make an award of interest in relation to each of the elements referred to in the section, namely the rate, the sum to bear interest and the period for which the interest is to accrue." [My emphasis.]

In the same case Reynolds JA said at p. 613 supra:

"In my view, the provision in section 94 is properly to be regarded as adjectival in character; see per Gibbs J, *Ruby v Marsh* (1975) 132 CLR 642 at p. 656. It provides an ancillary power akin to an order for costs and its purpose is to aid the court to do more complete justice between the parties than is otherwise possible. It does not confer a substantive right to interest upon creditors and persons who have suffered injury to personal property and its application is dependent upon proceedings being instituted in the Supreme Court and continuing to judgment. It is not designed to compensate a plaintiff for loss arising out of the cause of action, but to provide compensation where it is otherwise appropriate to do so for the circumstance that a sum of money has been outstanding to him for a period of time. One, but not necessarily the only factor is the inevitable delay between the cause of action, or institution of proceedings, and judgment. While the delay is inevitable, nevertheless the defendant has the use of the money during the period. A rate of interest for the period of delay affords the fair legal measure of compensation." [My emphasis.]

It is clear that the interest under section 94 is a notional amount which is determined in the discretion of the Court. It is not an amount which accrues as of right at periodic rests. Put another way, it is a lump sum equal to the accumulated notional interest between the date when the cause of action accrued to the date of judgment. It is "as if" interest had been charged during this period. When added to the common law damages of \$743,050 it established the judgment debt of \$808,564. Common law and statutory damages have been

blended or fused together to establish an indivisible debt. The amount paid to Mrs Whitaker in satisfaction of the judgment debt was a lump sum payment equal to this amount. Is it correct to say that part of this lump sum receipt attributable to the section 94 so-called interest "by way of statutory damages" was income derived by her?

What she received was a sum in discharge of a judgment debt being the sum of common law and statutory damages. Is there any warrant under section 25(1) of the Act to attribute part of the receipt as being income derived? For example, in the case of a liquidator's distribution, section 47(1) of the Act attributes part of it to be a dividend (income). Contrary to what Hill J said, no amount is payable as such under section 94. Section 25(1) of the Act says nothing about the apportionment or attribution of a gross receipt between income and a non-income amount. Menzies J in *Federal Commissioner of Taxation v Hatchett* (1971) 71 ATC 4184 said at p. 4186 "in the field of taxation, as in the field of business, capital is used in contrast with revenue; it has no reference to a man's body mind or capacity". It is submitted the essential character of the receipt of \$808,564 was of a non-income nature. In short, it is contended that for income to exist it must be a discrete and detachable item. Section 94 "interest" does not satisfy this criterion.

The decision in *Federal Wharf Co Ltd v Deputy Federal Commissioner of Taxation* (1930) 44 CLR 24 as explained by Hill J in *Whitaker's* case seems to be more relevant to section 95 of the Supreme Court Act 1970 (NSW) than to section 94. The contest in *Federal Wharf* case between the taxpayer and the Commissioner involved nine years of income (1920-1928) in which interest seems to have been received by the taxpayer in each of the years, albeit on a tentative compensation figure of £125,000, agreed in 1991 but later fixed at £159,580 in 1928. If 4% was the rate applied then initially £5,000 per annum would have been included as assessable income in each of the nine years of assessment. This appears to be more analogous to the operation of section 95 than section 94. Unlike the *Federal Wharf* case and section 95, no interest is payable as such under section 94. The only amount which is payable is an amount for damages being the judgment debt. The distinction between section 95 of the *Supreme Court Act*, section 26 of the *Harbors Act* 1913 (SA) is that the interest calculation is or was exclusive and payable separately, whereas under section 94 it is inclusive and neither severable nor separately payable.

If the decision in *Whitaker's* case was overruled then there may be scope for the application of the principle in *British Transport Commission v Gourley* [1956] AC 185. This may already have been the case because in determining the interest rate for past pain and suffering income tax appears to have been a factor taken into account when arriving at the commonly applied 4% interest rate.

"In the circumstances the use of the 4% figure seems to us to be more likely to achieve fair and reasonable

compensation for plaintiffs than the use of the real rate of interest figure - which may result at times in a plaintiff obtaining no or little interest and at other times an amount of interest greater than the return which could be achieved by real life investors (on a comparable sum after the incidence of income tax) see *MBP(SA) Pty Ltd v Gogic* (1991) 171 CLR 657 at p. 666."

Hill J at p. 23 of his reasons seems to have averted to this possibility when he said:

"Since the amount in essence reimburses a successful plaintiff in respect of the time in which the plaintiff has been out of pocket and at rates of interest equivalent, more or less, to commercial rates, not to charge tax upon the interest in fact operates to over-reimburse the successful plaintiff."

If *Whitaker's* case is not overruled then in the end the issue can only be resolved as a matter of public policy. That is whether interest by way of damages on common law damages for personal injuries should be subject to income tax. The United Kingdom has answered this question in the negative. Section 329 of the *Income and Corporation Taxes Act* 1988 (UK) provides as follows:

- "(1) The following interest shall not be regarded as income for any income tax purposes -
- (a) Any interest on damages in respect of personal injuries to a plaintiff or any other person or in respect of a person's death which is included in any sum for which judgment is given by virtue of a provision to which this paragraph applies; and"

In the United States interest awarded in a judgment is generally considered ordinary income regardless of how the judgment itself is taxed. See *Wheeler v Commissioner of Internal Revenue* 58 T. 459; and *Aames v Commissioner of Internal Revenue* 94 US TC 189.

Whitaker's case appears to raise at least one possible ground of appeal, namely whether there is any warrant under section 25(1) of the Act to attribute part of a receipt of a judgment debt for damages for personal injury referable to section 94 "interest" by way of damages, the character of income derived. If the decision stands, it begs the question as to why the loss of past income (loss of economic capacity for the past) should not also be characterised as assessable income.

To resolve such doubt Parliament should intervene to enact that all damages including "interest" arising from personal injuries are not assessable income. See section 104(a)(2) of the US *Internal Revenue Code* which excludes from gross income "the amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness". □