



IT365R2 Damages, settlements, and similar receipts

INCOME TAX ACT Damages, Settlements and Similar Receipts

IT-365R2 May 8, 1987 Section 3 (also section 6, subsections 5(1), 12.2(1) and (3), 14(1), 16(1), 56(1), and 248(1), paragraphs 81(1)(g.1) and (g.2) and subparagraphs 14(5)(a)(iv) and 56(1)(a)(ii)).

This bulletin replaces and cancels IT-365R dated March 9, 1981 and the Special Release to IT-365R which was issued on May 25, 1984. Current revisions are designated by vertical lines.

1. This bulletin deals with the treatment for tax purposes of amounts received (a) out of claims for damages for personal injury or death, (b) as compensation for the loss of property or income, (c) as crime compensation awards, and (d) on termination of employment.

Amounts received as Damages in Respect of Personal Injury or Death

2. Amounts in respect of damages for personal injury or death may be received by an injured taxpayer or by a dependant of a deceased taxpayer on account of: (a) Special damages - examples are compensation for (i) out-of-pocket expenses such as medical and hospital expenses, and (ii) accrued or future loss of earnings and (b) General damages - examples are compensation for (i) pain and suffering, (ii) the loss of amenities of life, (iii) the loss of earning capacity, (iv) the shortened expectation of life and (v) the loss of financial support caused by the death of the supporting individual. All amounts received by a taxpayer or the taxpayer's dependant, as the case may be, that qualify as special or general damages for personal injury or death will be excluded from income regardless of the fact that the amount of such damages may have been determined with reference to the loss of earnings of the taxpayer in respect of whom the damages were awarded. However, an amount which can reasonably be considered to be income from employment rather than an award of damages will not be excluded from income. The tax treatment of an award of compensation, as adjudicated by a compensation board or commission in Canada, which is received as a result of a worker having suffered injury, disability or death while performing the duties of employment, is explained in IT-202R2.

Awards Not Considered to be Annuities

3. An award of damages for personal injury or death that decrees that it be paid in periodic payments is not, despite such periodic payments, considered to be an annuity contract for the purposes of subsections 12.2(3) and 56(1) and the periodic payments themselves are not considered to be annuity payments. However, an annuity contract purchased by a taxpayer or a taxpayer's representative with proceeds of a lump sum award received for damages for personal injury or death will be an annuity contract for all purposes of the Act and will, except in the circumstances described in 6 below, give rise to income in the taxpayer's hands.

Interest Element of Awards for Personal Injury or Death

4. Where an amount in respect of damages for personal injury or death has been awarded by a Court or resolved in an out-of-court settlement, no part of such amount will be income to the recipient even though the amount includes or is augmented by an amount which, pursuant to the terms of the Court order or the settlement agreement, is referred to as interest. However, where an amount that has been awarded for damages is held on deposit, the amount of interest earned will be included in the income of the injured taxpayer unless paragraph 81(1)(g.1) or (g.2) has application (see 6 below). Where an amount that has been awarded for damages is held in trust, any interest earned on the amount is income of the trust or of the beneficiary, depending on the circumstances.

Structured Settlement

5. A "structured settlement" is a means of paying or settling a claim for damages, usually against a casualty insurer, in such a way that amounts paid to the claimant as a result of the settlement are free from tax in the claimant's hands. To create such a structured settlement the following conditions must be complied with: (a) a claim for damages must have been made in respect of personal injury or death, (b) the claimant and the casualty insurer must have reached an agreement under which the latter is committed to make at least periodic payments to the claimant for either a fixed term or the life of the claimant, (c) the casualty insurer must (i) purchase a single premium annuity contract which must be

non-assignable, non-commutable, non-transferable and designed to produce payments equal to the amounts, and at the times, specified in the agreement referred to in (b), (ii) make an irrevocable direction to the issuer of the annuity contract to make all payments thereunder directly to the claimant, and (iii) remain liable to make the payments as required by the settlement agreement (i.e., the annuity contract payout). As a consequence of compliance with the foregoing conditions, the casualty insurer is the owner of, and annuitant (beneficiary) under, the annuity contract and must report as income the interest element inherent in the annuity contract while the payments received by the claimant represent, in the Department's view, non-taxable payments for damages.

Income from Property that was Received by a Taxpayer Under 21 Years of Age as an Award of Damages for Personal Injury

6. For the 1984 and subsequent taxation years, paragraphs 81(1)(g.1) and (g.2) exempt from tax the income of a taxpayer from particular sources for taxation years during any part of which the taxpayer was under 21 years of age. To qualify for this exemption the income must, during the particular taxation years, be derived from one or more of the following sources: (a) property received by or on behalf of a taxpayer who is under 21 years of age as an award of, or pursuant to an action for, damages in respect of the taxpayer's physical or mental injury, (b) property substituted for property described in (a), (c) a capital gain derived from the disposition of property described in (a) or (b), or (d) invested income that was, by virtue of paragraph 81(1)(g.1) or (g.2), not required to be included in the taxpayer's income for a particular taxation year described above. For the purposes of paragraphs 81(1)(g.1) and (g.2) income will include income received and receivable and income accrued (i.e., earned but not received) up to, but not beyond, the end of the taxation year in which the taxpayer attains the age of 21 years.

7. For taxation years ending after 1971 and before 1984, former paragraph 81(1)(g.1) (a) caused the exempt period to end on the day immediately preceding the day on which the injured taxpayer attained the age of 21 years, and (b) restricted exempt income to income that was actually received while the injured taxpayer was under 21 years of age.

Receipts in Respect of Non-Performance of Business Contracts

8. An amount received by a taxpayer in lieu of the performance of the terms of a business contract by the other party to that contract may, depending on the facts, be either an income or capital receipt. If the receipt relates to the loss of an income-producing asset, it will be considered to be a capital receipt; on the other hand, if it is compensation for the loss of income, it will constitute business income. Again, while it is a question of fact as to whether a receipt is an income or capital amount, the following factors are important in making this distinction: (a) if the compensation is received for the failure to receive a sum of money that would have been an income item if it had been received, the compensation will likely be an income receipt, (b) "where for example, the structure of the recipient's business is so fashioned as to absorb the shock as one of the normal incidents to be looked for and where it appears that the compensation received is no more than a surrogatum for the future profits surrendered, the compensation received is in use to be treated as a revenue receipt and not a capital receipt", and (c) "when the rights and advantages surrendered on cancellation are such as to destroy or materially to cripple the whole structure of the recipient's profit-making apparatus, involving the serious dislocation of the normal commercial organization and resulting perhaps in the cutting down of the staff previously required, the recipient of the compensation may properly affirm that the compensation represents the price paid for the loss or sterilization of a capital asset and is therefore a capital and not a revenue receipt." ((b) and (c) above are quotations from the judgement in *Commissioner of Inland Revenue v. Fleming and Co. (Machinery) Ltd.*, 33TC57 (House of Lords)).

9. Where an amount received by a taxpayer as compensation for a breach of a business contract is a capital amount according to the comments in 8 above, that amount would relate either to a particular asset of the taxpayer or to the whole structure of the taxpayer's profit-making apparatus. If, on the basis of the facts of the case, such as the terms of a contract, settlement or judgement, the amount received relates to a particular asset (tangible or intangible) which is sold, destroyed or abandoned as a consequence of the breach of contract, it will be considered proceeds of disposition of that asset or a part thereof, as the case may be. Where the amount of compensation relates to a particular asset that was not disposed of, the amount will serve to reduce the cost of that asset to the taxpayer. On the other hand, where the amount of compensation is of a capital nature but it does not relate to a particular asset as indicated above, the amount will be considered as compensation for the destruction of, or as damages to, the whole profit-making apparatus of the taxpayer's business. Such

compensation may result in an "eligible capital amount" for the purpose of subsection 14(1) and subparagraph 14(5)(a)(iv).

Compensation for Loss of Business Income or Business Properties

10. Amounts received by a taxpayer with respect to the loss of business income or business property may fall into one of the following categories: (a) a non-taxable receipt, (b) an income receipt, (c) a receipt resulting from the disposition of a capital property, or (d) an eligible capital amount. See IT-182 for a discussion of the factors that determine the tax status of a given receipt.

Crime Compensation Awards and Similar Receipts

11. A number of provinces make crime-compensation awards pursuant to the authority of criminal-injury compensation laws. The Department considers that such crime-compensation awards are non-taxable.

12. A taxpayer who is a victim of a crime may receive compensation from a source other than the person who committed the crime or a crime-compensation board. For example, a male employee of a bank is kidnapped and upon his release the bank pays the employee an amount to compensate for "damages" inflicted on him. Where the amount of money or benefit received is compensation for damages the Department will normally consider the amount to be a non-taxable receipt even if the damages are computed with reference to the victim's salary. To qualify as a non-taxable receipt, the amount must not be in excess of a fair evaluation of the damages suffered by the employee having regard to all relevant facts of the case. The amount of the receipt will ordinarily be accepted as a fair evaluation unless there are indications (such as the employer and employee not dealing at arm's length) that the receipt includes an amount for services rendered by the employee to the employer. Any part of an amount received by a taxpayer from his employer, or former employer, that is compensation for loss of earnings (e.g., an amount paid in lieu of regular wages or benefits) resulting from a disability of short duration will be included in the income of the taxpayer.

13. Where a taxpayer, other than an employee, is in receipt of an amount that has not been awarded by a court or a crime-compensation board (a payment by a bank to a customer, for example) for "damages" inflicted as a result of a crime, the total amount is considered to be a non-taxable receipt.

Amounts Received on Termination of Employment

14. Applicable with respect to the termination of an office or employment occurring after November 12, 1981, the defined term "termination payment" was repealed by S.C. 1980-81-82-83, c.140. The definition of "retiring allowance" in subsection 248(1) was amended concurrently so that amounts that were previously included in the definition of a termination payment are now fully included in income as retiring allowances under subparagraph 56(1)(a)(ii). Retiring allowances are dealt with in IT-337R2

15. Where a taxpayer receives an amount pursuant to the terms of an employment contract, the amount is to be included in computing the taxpayer's income under subsection 5(1) or section 6, whichever may be applicable, as income from an office or employment, whether or not it is received on termination of the employment. Such an amount would include, for example, salary, wages, accrued vacation pay, and an amount paid in lieu of notice of termination.

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