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Wills, Taxes and  
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# Law

Issues in Law You Need To Know

## Taxation of Damages – What a Difference It Can Make

*At the conclusion of a long litigation matter, two questions sure to arise - how much was awarded and whether or not that award is taxable. Everyone agrees that a tax-free award is most desirable to the plaintiff.*

*Whether or not a particular award of damages is to be received on a tax-free basis depends upon the characteristics of the action, the pleadings, the methodology used by the trial judge and the actual calculation of the damages.*

Lawyers and their clients would be well advised to consider the tax implications of the damages sought from the outset. In some instances, the nature of the action clearly determines whether the damages will be taxable by rule of law.

In other cases, there may be the possibility of framing the cause of action for tax purposes; whether the damages are deemed income and, if so, are they capital gains or income.

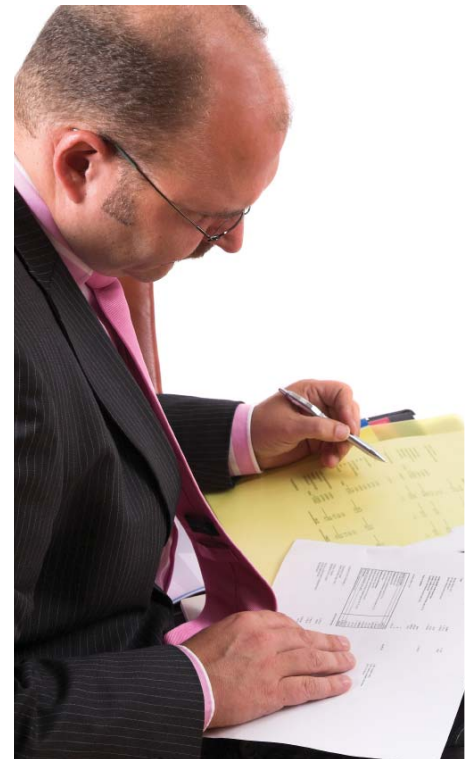
### **Damages Related to Personal Injury or Death**

The characterization of damages awarded in the context of an injured individual is key to determining whether the award may be received on a tax-free basis.

Damages awarded in respect to a personal injury or death are to be received by the injured party, or by the dependant of a deceased party, on a tax-free basis as long as the damages are special damages, general damages or pre-judgment damages.

Special damages in the context of personal injury relate to compensation such as out-of-pocket expenses (for medical and/or hospital expenses) and accrued or future loss of earning.

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.



General damages in the context of personal injury relate to compensation for pain and suffering, loss of amenities of life, loss of earning capacity, the shortened expectation of life and the loss of financial support caused by the death of the supporting individual (a parent for example).

Furthermore, damages that are awarded to be paid over a period of time by periodic installments are also to be received on a tax-free basis by the injured party; notwithstanding that it appears to be an annuity.

The CRA confirmed in its IT Bulletin 365 that damages for personal injury or death that are ordered to be paid in periodic payments are not, despite such periodic payments, considered to be an annuity contract and the periodic payments themselves are not considered to be annuity payments.

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 considered an annuity contract and will likely be taxable, with some limited exceptions.

### Business Related Damages

Determining the characterization of damages awarded on business matters and the resulting tax treatment can be difficult. The general principle is that damages in lieu of receipts that would have been taxable as income remain taxable.

Determining whether those damages are deemed income or non-taxable receipts depends on the nature of the legal right at issue. One must carefully review the facts and determine the purpose of the remedy; i.e., for what do the damages compensate?

If the damages awarded are for loss of income, then the general principle is that they will be considered business income and therefore taxable.

If the damages awarded relate to the loss of an income-producing asset, it will be considered to be a capital receipt and non-taxable. As one can imagine, the difference between loss of income and the loss of an income producing asset can be nuanced and there exists no bright-line test to differentiate the two; it is always a question of fact.

Essentially, if the damages received are for the failure to receive a sum of money that would have been income had it been received, the damages are likely deemed income receipt and taxable. Also, if the damages awarded are essentially a surrogatum for future profits surrendered, the damages will likely be treated as revenue receipts, not a capital receipt, and be taxable.

### Employment Related Damages

In most instances, employment related damages are awarded as compensation for a loss of employment and are specifically dealt within the Income Tax Act as "retiring allowances." Under the Income Tax Act, retiring allowances are fully taxable as income.

As a result, damages for wrongful dismissal, damages for compensation for lost earnings or damages on account of a contractually agreed settlement (such as a signing bonus) will all be taxable in the hand of the recipient.

Damages awarded by the Workers' Compensation Board for illness, injury or death ought to be included as income but the recipient is entitled to a deduction which essentially offsets the inclusion by excluding the damages award.

Also, damages awarded in context of a human rights violation, personal injuries (e.g. defamation or harassment) or tortious conduct by an employer are usually viewed as general damages unrelated to the loss of employment and are therefore non-taxable. Once again, the determination is a factual one.



## Conclusion

The taxation of damages awarded will inevitably affect the ultimate cost of recovery or indemnity. In some instances, the Income Tax Act will clearly dictate whether the damages are taxable. In other cases, a proper determination can only be made sometime after the commencement of the litigation process.

Ultimately, the only certainty is that some damages are taxable while others are not, that the analysis is a factual one and that the framing of the cause of action and the pleadings may formulate the determination.

At Tierney Stauffer LLP, you can be sure that lawyers litigate with their clients' best interest in mind

and that always includes making informed decisions with respect to taxation.

If you have any questions concerning the taxation of damages, please do not hesitate to contact me directly at 613.288.3220

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### CALL TO THE BAR

Law Society of Upper Canada, 2007

### EDUCATIONAL BACKGROUND

- University of Ottawa, LL.L., 2007
- University of Ottawa, LL.B., 2005
- Michigan State University, College of Law, J.D., 2005

### PRACTICE SUMMARY:

Sébastien joined Tierney Stauffer LLP as an Associate in the Wills, Estates & Trusts Planning & Administrative Practice Group in 2009. His practise focuses on estate planning, will drafting and personal and corporate taxation. Sébastien has experience in resolving disputes with the Canada Revenue Agency (CRA), filing voluntary disclosures, assisting individuals with their tax related issues and tax planning for families and businesses. Sébastien is bilingual and practices in both official languages.

He has spoken at various seminars on estate, trust and tax matters. Sébastien has also appeared on radio and television discussing legal issues. He is a tutor for the Law Society of Upper Canada for the Estate Practice section.

Prior to joining Tierney Stauffer LLP, Sébastien practiced with another Ottawa law firm where he gained experience in tax law, charity law, estate planning and will drafting.

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