LANGIND E
DOCNUM 2014-0522921E5
REFDATE 140724
SUBJECT Taxation of a settlement payment
SECTION ITA 3, 9(1)

PRINCIPAL ISSUES: Whether a settlement amount received is taxable?
POSITION: Question of fact.
REASONS: Based on the surrogatum principle, a settlement has the same tax treatment as the amount it is intended to replace.

XXXXXXXXXX

2014-052292
S. Trop

July 24, 2014

Dear XXXXXXXXXX:

Re: Taxation of a settlement payment

We are writing in response to your email dated February 25, 2014, concerning whether the amount received pursuant to a settlement agreement would be taxable or considered to be a non-taxable amount.

In the situation you described, you and your husband were involved in a dispute with an investment company for losses due to unsuitably invested accounts. As the litigation was settled out of court, there was no judicial ruling issued. The settlement amount made to you was to end the dispute but did not acknowledge that there was a wrongdoing.

Our Comments

This technical interpretation provides general comments about the provisions of the Income Tax Act (the "Act") and related legislation (where referenced). It does not confirm the income tax treatment of a particular situation involving a specific taxpayer but is intended to assist you in making that determination. The income tax treatment of particular transactions proposed by a specific taxpayer will only be confirmed by this Directorate in the context of an advance income tax ruling request submitted in the manner set out in Information Circular IC 70-6R5, Advance Income Tax Rulings.

Generally, an amount is taxable under the Act if it constitutes income from a source or if a specific provision of the Act applies to the type of payment. The underlying claim determines the tax treatment of amounts paid in settlement of the claim. A payment in settlement of a damages claim to avoid or terminate litigation may generally be accorded similar treatment for tax purposes as damages awarded in a judicial ruling, even though there may be no admission of wrongdoing. In reviewing the tax consequences of a settlement, the essential question is to determine what the settlement was intended to replace.

Ordinary Income

A settlement payment will be treated as ordinary income and taxable, if it compensates for the loss of an amount that would have been income, be it from business, property, or employment sources. A settlement payment received as compensation for loss of, or damage to, a capital asset, will generally be considered on account of capital and taxable as proceeds of disposition from property.

Personal Injury

A settlement payment, or a portion thereof, may also represent damages in respect of personal injury, in which case it or a portion thereof would be exempt from tax. Paragraph 2(a)(ii) of Interpretation Bulletin IT-365R2, Damages, settlements and similar receipts, describes an amount received on account of damages for accrued loss of earnings as special damages in respect of personal injury, regardless of the fact that the amount of such damages may have been determined with reference to the loss of earnings.

Windfall

An amount is not taxable under the Act if it constitutes a windfall for the person receiving it. Factors indicating that a particular receipt is a windfall include the following:

(a) the taxpayer had no enforceable claim to the payment;
(b) the taxpayer made no organized effort to receive the payment;
(c) the taxpayer neither sought after nor solicited the payment;
(d) the taxpayer had no customary or specific expectation to receive the payment;
(e) the taxpayer had no reason to expect the payment would recur.

The settlement payment in the situation you described would not be considered a windfall as both you and your husband pursued compensation for your losses.

The taxation of settlement payments for income tax purposes is generally based on the nature and purpose of the settlement payment, which is a question of fact. In most cases, the parties to the settlement agreement are in the best position to make this determination. If it is determined that the payment, or portion thereof, was compensation for actual financial losses resulting from the bad investment advice (i.e., tort of negligence), the payment or a portion thereof would likely be considered damages for personal injury and not taxable. Any part of the settlement payment that was intended to compensate for investment income, which would have been earned had there been no negligence, would be considered income from property and taxable.

We trust these comments will be of assistance to you.

Yours truly,

Nerill Thomas-Wilkinson, CPA, CA
Manager
Business and Employment Income Section
Business and Employment Division
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