

# ***TR 2012/8EC - Compendium***



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## **Ruling Compendium – TR 2012/8**

This is a compendium of responses to the issues raised by external parties to draft Taxation Ruling TR 2012/D2 *Income tax and fringe benefits tax: assessability of amounts received to reimburse legal costs incurred in disputes concerning termination of employment*.

This compendium of comments has been edited to maintain the anonymity of entities that commented on the draft Ruling.

### **Summary of issues raised and responses**

<b>Issue No.</b>	<b>Issue raised</b>	<b>ATO Response/Action taken</b>
1	<p>We agree that:</p> <ul style="list-style-type: none"><li>• an amount received in relation to a dispute concerning termination of employment is not an ETP where the amount is capable of being identified as relating specifically to legal costs, and</li><li>• if the amount of a settlement or court award received is an undissected lump sum, where the component of the receipt that relates to legal costs has not been and cannot be determined, then the whole amount is treated as being received in consequence of termination of employment.</li></ul>	<p>Confirms the position taken in the draft Ruling. No action required.</p>
2	<p>The draft Ruling is inconsistent with views expressed in earlier Private Binding Rulings.</p> <p>The draft Ruling relies on the same cases referred to in the Private Binding Rulings but reaches the opposite conclusion.</p> <p>The draft Ruling is inconsistent with views expressed in general advice issued by the ATO (copies supplied).</p> <p>If the ruling is to issue with its current conclusions it should apply prospectively as it is inconsistent with previous ATO view documents.</p> <p>The inconsistency causes a problem for employers who have relied on the ATO's earlier position and may be liable for FBT.</p> <p>The draft Ruling should not apply where it has detrimental effects for persons relying on the previous ATO position.</p>	<p>Taxation Ruling TR 2006/10 <i>Public Rulings</i> explains that there are situations where it is appropriate for a public ruling to have a prospective date of application. For example where the ATO has facilitated or contributed to taxpayers adopting a different view of the law.</p> <p>It is acknowledged that there was no previous published ATO view document concerning legal expenses as an ETP and that the ATO issued a number of private rulings and provided other guidance that took the opposite view to this Ruling. There are also a number of edited versions on the ATO's website which suggest a different view to that in the final ruling.</p> <p>This is consistent with the ATO's approach as set out in PS LA 2011/27 and Taxation Determination TD 2011/19.</p> <p>Accordingly, the ruling will not apply to reimbursed legal costs awarded or received (including under a settlement) before the date of issue of the Ruling where taxpayers treated the reimbursement as forming part of an</p>

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		<p>ETP (including where this treatment was in reliance on a private ruling), and that treatment results in the taxpayer receiving a more favourable tax outcome than under this Ruling.</p> <p>This is consistent with the ATO's approach as set out in PS LA 2011/27 and Taxation Determination TD 2011/19.</p> <p><b>The effect of this public ruling for Taxpayers with existing private rulings is as follows:</b></p> <p><b>Taxpayers whose private ruling is more favourable</b></p> <p>TR 2006/11 states at paragraph 70 that a public ruling that is not an indirect tax or excise ruling that relates to a scheme and that changes the Commissioner's general administrative practice (or conflicts with a previous private ruling) cannot apply to a particular entity if:</p> <ul style="list-style-type: none"> <li>the change is less favourable to the entity than the practice or ruling; and</li> <li>the entity has started to carry out the scheme.</li> </ul> <p><b>Taxpayers whose private ruling is less favourable</b></p> <p>TR 2006/11 at paragraph 6 explains that where a taxpayer relies on a private ruling and the correct application of the relevant provision of the law actually gives a more favourable result, the Commissioner may nevertheless apply the correct view of the relevant provision as if the taxpayer had not relied on the private ruling.</p>
3	<p><b>Meaning of 'in consequence' of termination of employment</b></p> <p>The Ruling is wrong in law as a legal expense award should be considered an ETP under section 82-130 of the <i>Income Tax Assessment Act 1997</i> (ITAA 97).</p> <p>The draft Ruling identifies the purpose of making a payment for legal costs as being to indemnify the successful party and as a result concludes the payment is not paid 'in consequence of termination'.</p> <p>This approach is wrong as it focuses on the dominant purpose of the payment rather than the cause of the payment. The purpose of paying legal costs is to indemnify the other party but it is not the sole cause of the payment.</p> <p>The approach taken in the draft Ruling is contrary to case law which has</p>	<p>Taxation Ruling TR 2003/13 <i>Income tax: eligible termination payments (ETP): payments made in consequence of the termination of any employment: meaning of the phrase 'in consequence of'</i> sets out the ATO view that, while termination does not need to be the dominant cause of the payment, there does need to be a causal connection between the termination and the payment which is not broken by an intervening event, such that the degree of connection between the termination and payment is too remote.</p> <p>The view expressed in this Ruling is that there is a relevant intervening event when the former employee incurs legal expenditure in a dispute concerning the termination of employment in circumstances where:</p> <ul style="list-style-type: none"> <li>legal costs are incurred after the cause of action arose</li> </ul>

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	<p>held that for a payment to be ‘in consequence’ of the termination of employment the termination does not have to be the dominant cause of the payment so long as the payment follows as an effect or result of termination. (<i>McIntosh v. FC of T</i> (1979) 25 ALR 557; <i>Reseck v. FC of T</i> (1975) 133 CLR 45; <i>Le Grand v. FC of T</i> [2002] FCA 1258).</p> <p>The payment of legal costs is a consequence of the settlement of a Court order, which is in consequence of the legal proceedings, which in turn is a consequence of the termination of employment. If the substance of the legal proceedings relates to the termination of employment, an amount paid to settle the legal proceedings (including legal costs) will be an ETP as it is made ‘in consequence of’ termination. (See <i>Le Grand v. FC of T</i> [2002] FCA 1258 and <i>Dibb v. FC of T</i> [2003] FCA 673.)</p> <p>Paragraph 5 of TR 2003/13 <i>Income Tax: eligible termination payments (ETP): payments made in consequence of the termination of any employment: meaning of the phrase ‘in consequence of’</i> confirms the appropriateness of the ‘but for’ test in relation to determining whether a payment is made ‘in consequence of termination of employment’.</p> <p>Paragraph 29 of TR 2003/13 indicates that based on case law the Commissioner considers there are two interpretations of the meaning of ‘in consequence of termination of employment’ and the narrower view accords more closely with the ordinary meaning of ‘consequence’.</p> <p>Paragraph 29 states: ‘The narrower interpretation requires that there be a causal connection in the sense that the payment follows as an effect or result of the termination of employment. That is, but for the termination of employment the payment would not have been made to the taxpayer.’</p> <p>In relation to a payment made to settle wrongful dismissal (or similar claims) paragraph 31 of TR 2003/13 states: ‘the payment will have a sufficient causal connection with the termination of the taxpayer’s employment. The payment will be taken to have been made in consequence of the termination of employment because it would not have been made but for the termination.’</p> <p>Paragraph 31 of TR 2003/13 is quoted at paragraph 23 of the draft Ruling and states:</p> <p>‘...when a payment is made to settle a claim brought by a taxpayer for wrongful dismissal...the payment will have a sufficient causal connection with the termination of the taxpayer’s employment. The payment will be taken to have been made in consequence of the termination of</p>	<ul style="list-style-type: none"> <li>at the time that the costs are incurred there is no right to recover those costs and there is no certainty as to the amount that might be recovered (costs can only be awarded at the discretion of the Court) and</li> <li>the costs do not form part of the damages for the underlying cause of action.</li> </ul> <p>The legal expenditure, incurred after termination, is not factually ‘interwoven and intertwined’ with the fact of termination of employment in the sense which Justice Goldberg found in <i>Le Grand v. FC of T</i>.</p> <p>Payments to reimburse legal expenses do not arise from the termination of employment. This can be distinguished from the decision in <i>MacIntosh</i>, where the court found that the intervening event (commutation of a pension) merely changed one form of payment into another. The facts are also different to those in the Federal Court in <i>FCT v. Pitcher</i> where Justice Ryan found that the termination of employment was a necessary prerequisite for and cause of, the respondent’s entitlement to a redemption payment under the <i>Safety, Rehabilitation and Compensation Act 1988 (Cth)</i>.</p> <p>Although a successful party may have a reasonable expectation that they will receive an award of legal costs, this is at the discretion of the court, and that discretion is exercised by reference to the way in which the parties conduct the litigation, rather than the conduct which gave rise to the right to seek compensation.</p> <p><b>Alternate view</b></p> <p>On the alternate view, as raised in comments on the draft Ruling, incurring costs to dispute the termination of employment is not an intervening event that breaks the causal connection between the termination and the reimbursement of those legal costs.</p> <p><b>Causal Connection</b></p> <p>If the termination of employment had not occurred there would have been no need for an action to be brought to dispute that termination. Justice Goldberg in <i>Le Grand</i> found that a payment made to settle a claim brought for wrongful dismissal will have sufficient causal connection with the termination of employment to be taken to have been</p>

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	<p>employment because it would not have been made but for the termination.'</p> <p>The payment referred to in this paragraph may include an amount for legal costs. It is considered that paragraph 31 of TR 2003/13 and paragraph 23 of the draft Ruling supports the conclusion that the payment of legal costs to settle a dispute relating to the termination of employment would not be made <i>but for</i> the termination of employment and is therefore made in consequence of termination of employment.</p> <p>Paragraphs 24, 27 and 28 of the draft Ruling acknowledge that an award of legal expenses or legal expenses identified in an out of court settlement is paid as a result of the legal action taken in relation to a dispute about the termination of employment. The payment would not be made <i>but for</i> the termination of employment and is therefore made in consequence of termination of employment.</p>	<p>made in consequence of the termination of employment because the payment would not have been made but for the termination. It follows that such payment would not have been made but for the commencement of the action with the consequent incurring of the legal costs.</p> <p>It is foreseeable that where a dispute arises from the termination of employment legal costs may need to be incurred. 'But for' the termination, the legal costs would not have been incurred.</p> <p>A payment received as the result of that dispute which is associated with termination of employment has been held to be paid in consequence of termination of employment.</p> <p>Justice Goldberg held in <i>Le Grand</i> at paragraph 35:</p> <p style="padding-left: 40px;">'I am satisfied that the payment was an effect or result of that termination in the sense that there was a sequence of events following the termination of employment which had a relationship and connection which ultimately led to the payment.'</p> <p>The incurring of legal costs can be seen as part of a sequence of events that follows on from the termination of employment. Further the incurring of these legal costs does not have simply a temporal connection to the termination nor does it exist as a mere antecedent event to payment. The incurring of legal costs bears a relationship and connection to the termination of employment via the dispute that was consequent upon the termination.</p> <p>The relationship and connection to the termination that the legal costs bear continues through to the point that a Court, exercising its discretion awards an amount for costs or an amount for costs is agreed in settlement of the dispute. In this way the incurring of the legal costs cannot be seen as an intervening event that severs their causal connection to the termination.</p> <p><i>Dominant Cause</i></p> <p>The reimbursement of legal costs must have a causal connection with the termination, although the termination need not be the dominant cause.</p> <p>In <i>Reseck</i>, Justice Jacobs, when concluding that the payment of an allowance was paid in consequence of the termination of employment</p>

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		<p>held at 4219:</p> <p>‘It was submitted that the words ‘in consequence of’ import a concept that the termination of employment was the dominant cause of the payment. This cannot be so. A consequence in this context is not the same as a result. It does not import causation but rather a ‘following on’.’</p> <p>Accepting the general principle that an award of legal costs is to indemnify the successful party so that they are not out of pocket for their legal expenses does not preclude there being a causal connection between the termination and the payment.</p> <p>It is clear that the ordinary rule is that costs follow the event in proceeding before the Court. Consequently a successful party has a reasonable expectation of an award of costs to be paid by the opposing party but has no right to such an order as it will depend upon the exercise of the Court’s discretion and on the operation of any rules concerning the awarding of costs in that particular jurisdiction.</p> <p>In exercising its discretion a Court may not act arbitrarily. It should make such costs order as the justice of the case requires. Established principles require consideration of the grounds connected with the case, the circumstances leading to the litigation as well as the actual conduct of the parties.</p> <p>A payment for legal costs may also be received as the result of the parties agreeing to resolve the dispute by way of settlement. In these situations there is no exercise of the Court’s discretion.</p> <p>On the alternate view the amount received in relation to a dispute concerning termination of employment where the amount is capable of being identified as relating specifically to legal costs would be assessable as an ETP. The payment would not be an assessable recoupment under Subdivision 20-A as it is otherwise included in assessable income.</p> <p>As explained above, the Commissioner considers that the reimbursement of legal costs is not paid in consequence of termination of employment because the incurring of legal costs to bring an action in relation to a dispute concerning termination of employment will be an intervening event that severs the causal connection between the termination and an amount received relating specifically to those legal</p>

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		costs.
4	<p><b>Scope of Ruling – legal costs</b></p> <p>Deductibility of legal costs (paragraphs 29 to 36 of the draft Ruling) is a significant issue and should be in the binding part of the Ruling.</p> <p>The rules regarding deductibility should be explained more broadly to reflect recent judicial decisions that have allowed deductibility for legal costs relating to employment. For example:</p> <ul style="list-style-type: none"> <li>• <i>Commissioner of Taxation v. Shane Day</i> 2008 ATC 20-064 – expanded the types of circumstances where legal costs may be deductible in cases where an employee takes action to defend against charges that might impact on their continued employment.</li> <li>• <i>Spriggs and Anor v. Commissioner of Taxation</i> 2009 ATC 20-109 – deals with the deductibility of expenses incurred by employees in relation to their income earning activities.</li> </ul> <p>The examples do not sufficiently clarify the tax treatment of legal costs and in what circumstances they are deductible or of a capital nature. A distinction between capital expenses and income producing expenses should be clarified taking into account the principles from the cases referred to in the ruling.</p> <p>Example1 – It should be clear in the example that the action is not in relation to contractual rights to income.</p> <p>Example 2 – It is not clear in the example whether employment has ceased. A comment should be made in the example that the deductibility of the legal costs and the assessability of the recoupment is the same in this example whether or not the employment has ceased.</p>	<p>A more comprehensive discussion on the deductibility of legal costs is outside the scope of the ruling.</p> <p>A reference to TD 93/29 has been included in a footnote at paragraph 44 of the final ruling. TD 93/29 is about the deductibility of legal costs to recover wages paid by a dishonoured cheque. This TD was amended after <i>Romanin v. Commissioner of Taxation</i> [2008] FCA 1532; 2008 ATC 20-055; (2008) 73 ATR 760, and consequently applies to treat costs incurred to dispute the receipt of income contractually owed under an employment contract as on revenue account and allowable as a deduction.</p> <p>We have amended the examples to include the changes suggested in this feedback.</p>

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5	<p><b>Scope of the Ruling – Fringe benefits tax (FBT) and PAYG</b></p> <p>As the ruling overturns established ATO practice of treating the payment of legal costs as an employment termination payment the FBT and PAYG consequences should be included in the final ruling or they should be included in a separate ruling.</p> <p>Employment termination payments (and previously eligible termination payments) are excluded from the definition of ‘fringe benefit’ in section 136 of the <i>Fringe Benefits Tax Assessment Act 1986</i>. FBT may now apply to the payment if it is no longer an ETP.</p> <p>The tax payable on settlements is a material matter for employers and employees in settlement negotiations. It is important for employers to know what FBT, if any, may be payable.</p>	<p>The ruling will include an explanation of why FBT does not apply to reimbursed legal costs incurred in disputes concerning termination of employment.</p> <p>The definition of ‘fringe benefit’ in subsection 136(1) of the <i>Fringe Benefits Tax Assessment Act 1986</i> (FBTAA) the term includes a benefit provided to an employee by an employer ‘in respect of the employment of the employee’ but excludes certain benefits listed in paragraphs (f) to (s) of the definition. Relevantly paragraph 136(1)(c) of the FBTAA excludes an ETP from the definition of ‘fringe benefit’.</p> <p>However, as an amount received as a reimbursement of legal costs is not an ETP, consideration needs to be given to whether the payment is made ‘in respect of the employment of the employee’.</p> <p>The expression ‘in respect of the employment of the employee’ was considered by the Full Federal Court in <i>J &amp; G Knowles v. FCT</i> [2000] FCA 196; 44 ATR 22; 2000 ATC 4151. The Full Federal Court noted that:</p> <p style="padding-left: 40px;">... Whatever question is to be asked, it must be remembered that what must be established is whether there is a <i>sufficient</i> or <i>material</i>, rather than a causal connection or relationship between the benefit and the employment.</p> <p>The test for the connection between the benefit and the employment for FBT purposes is not the same as the test between the termination of employment and the payment for ETP purposes which relies on a causal connection.</p> <p>Where the link between the reimbursement of legal costs and the termination of employment has been severed such that the payment is not ‘in consequence of’ termination of employment, the payment will also not be ‘in respect of employment of the employee’, unless there is some other factor which suggests a sufficient or material connection between the benefit and the employment.</p>



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6	<p><b>Scope of the Ruling – Capital gains tax (CGT)</b></p> <p>The Ruling should comment on the CGT treatment of legal cost reimbursements when the amounts are received on capital account. For example in the case where the legal costs were in relation to compensation for wrongful dismissal, the CGT treatment in most cases could be summarised as follows:</p> <ul style="list-style-type: none"> <li>• The legal costs would be included in either the second or fifth elements of the cost base for the right to compensation for wrongful dismissal as a result of subsections 110-25 (2) or (6);</li> <li>• The recoupment of the legal costs would reduce the cost base for the right to compensation for wrongful dismissal as a result of subsection 110-45(3);</li> <li>• The capital gain for the receipt of the compensation receipt for wrongful dismissal (CGT event C2) is disregarded as a result of section 118-37.</li> </ul> <p>As the CGT treatment for compensation receipts is dealt with in TR 95/35, it is suggested that a reference to the treatment of compensation receipts be placed in the Ruling (although there is a note referring to TR 95/35 at the end of TR 2012/D2, it is not in the context of CGT).</p>	<p>We agree that for CGT purposes, the relevant CGT asset in litigation concerning wrongful dismissal is a right to seek compensation and any capital gain for the receipt of the compensation receipt for wrongful dismissal (CGT event C2) is disregarded as a result of section 118-37.</p> <p>Taxation Ruling TR 95/35 <i>Income tax: capital gains: treatment of compensation receipts</i> sets out the Commissioner's view on the CGT treatment of compensation receipts, including as a result of court proceedings.</p> <p>A note will be added to the ruling to explain that TR 95/35 deals with the CGT treatment for compensation receipts.</p>
7	<p><b>Apportionment</b></p> <p>It is unclear when the facts and circumstances surrounding an undissected lump sum will allow an apportionment to identify the component relating to legal costs – paragraph 5 and 49 of the draft Ruling.</p> <p>We suggest another example be included to assist in identifying situations where this will occur.</p> <p>A footnote is made to examples at paragraphs 190 to 209 of TR 95/35 but these paragraphs do not provide guidance as to when it would be reasonable to apportion an undissected lump sum as relating in part to legal costs.</p> <p>There needs to be certainty as to the amount of the legal costs as an ETP is subject to PAYG withholding.</p> <p>The ruling should address the circumstances when part of an undissected lump sum can be apportioned. It should address the</p>	<p>The Commissioner's view on apportionment is discussed in TR 95/35 and Taxation Determination TD 93/58. The ruling now contains a reference to both of those rulings, and also provides additional guidance on when agreement as to apportionment may be implied from the terms of settlement between the parties.</p> <p>The examples have also been updated to include a situation where an employee provides a bill for legal costs to the employer as part of settlement negotiations, and to include an example of an implied agreement between the parties to apportion a payment.</p> <p>Further content on apportionment is outside the scope of the ruling.</p>

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	<p>following:</p> <ul style="list-style-type: none"> <li>• Can correspondence between the parties containing a claim for legal costs be used to provide a basis for apportionment?</li> <li>• Does the proposed amount need to be acknowledged by the other party?</li> <li>• Can a statement made in negotiations or at mediation be sufficient to identify the amount of legal costs?</li> </ul> <p>Will any of the above be influenced by an amount the employee directs the former employer to pay to the employee's lawyers?</p>	
8	<p><b>Examples</b></p> <p>The examples should be more complex and clarify more issues. They currently explain simple scenarios where the results are clear based on the wording of the draft Ruling.</p> <p>The examples are confusing and appear inconsistent with the judgments they are based on.</p> <p>The examples do not appear to appreciate the nature of damages and the fact that in many cases there may well be various heads of damage. It would be helpful to incorporate relevant tribunal and court decisions in a precise way in the examples provided.</p> <p>The examples should be consistent with the present employment and industrial laws. They are not consistent with the unfair dismissal laws under the <i>Fair Work Act 2009</i> (FW Act) and the <i>Industrial Relations Act 1996</i> (NSW). Under these Acts there is a maximum award for unfair dismissal of six months pay. Under the FW Act it is capped at \$59,050. Further costs are rarely awarded under the FW Act and only if the claim is frivolous or vexatious or a party has acted unreasonable in not accepting an offer of settlement.</p> <p>Example 3 is inconsistent with the unfair dismissal laws under these Acts. It could be consistent with an adverse action claim under the General protection provisions under Part 3.1 of the FW Act where damages are not limited and the types of damages are not limited to economic loss, although loss on income is a significant component. However costs are not awarded in these claims except on rare occasions.</p> <p>Example 4 is inconsistent with the remedies under the Acts, such</p>	<p>The examples have been updated to respond to specific criticism in the feedback.</p> <p>In particular, the examples have been updated to remove any inconsistencies with terminology used in the <i>Fair Work Act 2009</i>.</p> <p>Example 3 has been updated to make it clear that it is a settlement of a matter which would not be subject to the jurisdiction of Fair Work Australia, as the employee's salary is above the statutory threshold for the application of the <i>Fair Work Act 2009</i>.</p> <p>While we accept that it may be the practice of employers not to include any amount in a settlement sum in respect of legal costs where the dispute arises in a 'no-cost' jurisdiction, it is not possible to include such an example in the ruling, as the Ruling expressly applies only to amounts which are paid in respect of legal expenses. The Ruling has no application to a situation where the parties have agreed to settle an employment termination dispute and agree that each party is to bear their own costs.</p>

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	<p>remedies having existed for many years under previous legislation. Unliquidated damages are not available to a litigant who brings an unfair dismissal claim and costs are only awarded in very rare circumstances. The examples should be relevant to matters that commonly arise for practitioners – unfair dismissal claims, breach of contract and adverse action claims.</p> <p>The examples do not include the most common employment law case – a settlement of an unfair dismissal claim in a jurisdiction where costs cannot be awarded. In such a case what is being settled is the claim not the costs. Comments suggest that where legal costs can't be recoverable in a jurisdiction costs cannot be a component of settlement. Refers to footnote 14 of draft Ruling.</p> <p>The examples are ambiguous when it comes to legal costs being a component of the settlement in a jurisdiction where each party pays their own costs. The statements in the draft Ruling may lead to employers being pressured into calling part of the settlement a reimbursement of costs when costs could not be part of the claim in a cost free jurisdiction. In such jurisdictions costs can only be ordered against an employer if a settlement proposal is unreasonably refused – but that doesn't happen if there has been a settlement.</p>	
9	<p>The final ruling should clarify whether it is intended to apply to identified legal costs relating to claims settled prior to formal legal proceedings in a relevant court or tribunal. The draft Ruling appears to apply to these claims and not be limited to situations where formal proceedings have commenced. (Examples 1 and 2 in the draft Ruling refer to 'awards' and 'court enforced' entitlements, examples 3 and 4 only refer to 'legal action' being commenced and settled.)</p>	<p>The second sentence from paragraph 3 of the draft Ruling has been moved under the heading 'what this ruling is about' to clarify that the ruling is intended to apply to court orders and settlements agreed to by the parties whether they are approved by a court order or not. The ruling will apply to reimbursement of legal costs relating to claims settled before formal legal proceedings commence.</p> <p>The ruling has also been amended to clarify that it applies to professional legal expenses incurred both before and after commencement of litigation.</p>
10	<p>The draft Ruling would be likely to lead to structuring by taxpayers and employers in negotiation settlements to minimise overall tax. For example, employers may be willing to pay a higher settlement if FBT is not payable on a component of identified legal costs.</p>	<p>The draft Ruling has been issued to clarify the taxation implication of an amount received to reimburse legal costs incurred in a dispute concerning termination of employment. The clarification should assist all parties in negotiation.</p>