

Canada Revenue Agency Notice

Notice 202

August 30, 2005

FOR DISCUSSION PURPOSES ONLY

Draft GST/HST Policy Statement, *Tax status of damage payments – whether or not within subsection 182(1) of the Excise Tax Act*

This revised policy statement is being disseminated by the Canada Revenue Agency in draft form for comments. Comments or suggestions should be sent by October 31, 2005 to:

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GST/HST Policy Statement

P-218R	Tax status of damage payments – whether or not within section 182 of the <i>Excise Tax Act</i>
DATE OF REVISION	xxxxx, 200x. This policy statement replaces P-218, dated May 25, 1998.
LEGISLATIVE REFERENCE	<i>Excise Tax Act</i> (the Act): Subsection 123(1) – Definitions of “consideration”, “supply”, “taxable supply”, “property”, “personal property” “money” and “service”; subsections 165(1) and (2) – Imposition of GST and HST; and subsection 182(1) – Forfeiture, extinguished debt, etc.
NATIONAL CODING SYSTEM FILE NUMBER	11735-1
EFFECTIVE DATE	January 1, 1991 for GST and April 1, 1997 for HST

Issue

This policy statement explains the application of section 182 of the *Excise Tax Act* (the Act) in the context of damage payments. For purposes of this policy statement, a damage payment is the payment of an amount of money from one person to another as compensation or indemnification for damages (e.g., property damage, loss of income, inconvenience) that the first person has caused the second person to suffer, or allegedly suffer.

Decision

A damage payment or other amount that is paid other than as consideration for a supply that was to be made under an agreement may nevertheless fall under the deeming provision in subsection 182(1) of the Act, resulting in a GST/HST liability. Subsection 182(1) may apply where, as a consequence of the breach, modification or termination of an agreement for the making of a taxable supply (other than a zero-rated supply) of property or a service in Canada by a registrant, an amount is paid or forfeited to that registrant otherwise than as consideration for that supply. Subsection 182(1) can also apply under the same conditions where a debt or other obligation of the registrant supplier is reduced or extinguished without payment on account of the debt or obligation.

However, there are situations where one or more of the conditions in subsection 182(1) are not met. These situations include:

- no prior agreement for the making of a supply existed between the parties;
- the original agreement was for the making of an exempt or a zero-rated supply;
- the amount is not paid or forfeited to the supplier of the original supply, or used to reduce or extinguish a debt of the supplier, e.g., where the person making the payment is the supplier of the original supply;
- the original agreement was for the making of a supply by a person who was not a registrant;
- the payment is consideration for the supply under the agreement; or
- the amount is paid otherwise than as a consequence of the breach, modification or termination of the agreement for the making of a supply.

Each of these situations relates to the wording of subsection 182(1).

There are circumstances where one person makes a payment to another person as compensation for damages and the payment is not subject to GST/HST. However, there are also situations where a payment is made in the context of a claim for damages, but the payment can be linked to the provision of a taxable supply of property or a service made by the payee in return for the payment, and for which purpose the payment is being made. This type of payment would be subject to GST/HST.

There are also situations where a person, rather than compensating another person by a payment of money, contracts with a third party to repair the damage to the other person. If, for example, a person breaks someone else's window and contracts with a third party to repair the window, the third party is making a taxable supply of a service of repairing a window to the person. As the person who is liable for the payment under the agreement with the third party, the person is the recipient of the service. The third party, if a registrant, would collect GST/HST from the person.

Examples

EXAMPLE NO. 1

Facts

1. Aco and Bco entered into an agreement that Bco, a GST/HST registrant, was to make a taxable supply of custom software to Aco.

2. Before the scheduled delivery date, Aco cancelled the order, but agreed to pay an amount to Bco to compensate it.
3. Aco did not receive any software as a consequence of making the payment.

Decision

The payment by Aco to Bco is deemed to be subject to GST/HST.

Rationale

Subsection 182(1) applies to the payment, since all the requirements of the subsection have been met. The payment is an amount other than consideration for the supply under the agreement. The payment is made as a consequence of the breach or termination of an agreement for the making of a taxable supply by a registrant, and the payment is made to that registrant. Consequently, 100/107 or 100/115 of the payment amount is deemed to be consideration on which GST or HST is deemed to have been paid.

EXAMPLE NO. 2

Facts

1. Dco and Eco entered into an agreement that Eco, a GST/HST registrant, would supply 1000 widgets per month to Dco for a period of 6 months.
2. After the first 3000 widgets were delivered, Dco requested that the remaining portion of the order be modified to 1500 widgets, instead of 3000. Dco agreed to pay Eco an amount in addition to the consideration for the widgets, in order to get Eco to agree to the modification of the original agreement.
3. Dco received a total of 4500 widgets from Eco.

Decision

The payment by Dco to Eco for the modification of the agreement is deemed to be subject to GST/HST.

Rationale

Subsection 182(1) applies to the payment, since all the requirements of the subsection have been met. The payment is an amount other than consideration for the supply under the agreement. The payment is made as a consequence of the modification of an agreement for the making of a taxable supply by a registrant, and the payment is made to that registrant. Consequently, 100/107 or 100/115 of the payment amount is deemed to be consideration on which GST or HST is deemed to have been paid.

EXAMPLE NO. 3

Facts

1. Gco, a GST/HST registrant, made a taxable supply of leased equipment to Fco.
2. While using the equipment, an employee of Fco damaged it by using it in a manner contrary to what was permitted under the lease agreement. Fco agreed to pay an amount to Gco to compensate it for the damage to its equipment.

3. Fco did not receive anything as a consequence of making the payment.

Decision

The payment by Fco to Gco is deemed to be subject to GST/HST.

Rationale

Subsection 182(1) applies to the payment, since all the requirements of the subsection have been met. The payment is an amount other than consideration for the supply under the agreement. The payment is made as a consequence of the breach of an agreement for the making of a taxable supply by a registrant, and the payment is made to that registrant. Consequently, 100/107 or 100/115 of the payment amount is deemed to be consideration on which GST or HST is deemed to have been paid.

EXAMPLE NO. 4**Facts**

1. Hco, a registrant, contracted with Ico, a registrant, whereby Ico would design and install a new software program for implementation by a certain date.
2. As the deadline date approached, it became obvious that Ico would not be able to fulfill its obligations under the contract.
3. Hco incurred additional expenses as a result of the non-delivery of the new software program.
4. Pursuant to negotiations, Hco agreed to release Ico from the contract in exchange for a sum of money.

Decision

The payment by Ico to Hco is not subject to GST/HST.

Rationale

The payment is in essence compensatory. It represents compensation for additional expenses incurred and that would be incurred as a result of the non-delivery of the new software program and is meant to restore, to some degree, Hco to the position it was in prior to the damage occurring.

No GST/HST is deemed to have been paid under subsection 182(1) as a consequence of the payment made by Ico to Hco. One of the requirements for subsection 182(1) to apply is that the payment must be made to the person who was to be the supplier under the original agreement, which is not the case in this example.

EXAMPLE NO. 5**Facts**

1. Dr. X, a plastic surgeon, was sued by one of his patients, Mr. Y, for negligence.
2. The case proceeded to trial and at the conclusion of the trial, the court held that Mr. Y had suffered a significant amount of pain and humiliation as a result of Dr. X's negligence.
3. Accordingly, the court ordered the payment of an amount of money to Mr. Y as compensation.

Decision

The payment by Dr. X to Mr. Y is not subject to GST/HST.

Rationale

The payment is in essence compensatory. It represents compensation for the pain and humiliation suffered.

Subsection 182(1) does not apply, since one of the requirements of subsection 182(1) is that the payment must be made to the person who was to be the supplier under the original agreement, which is not the case in this example.

EXAMPLE NO. 6**Facts**

1. Ms. A lost control of her vehicle and smashed into the display window of a business establishment (B Ltd.), a registrant.
2. B Ltd. performed the necessary repairs and demanded compensation from Ms. A in the amount of the cost incurred to repair the damaged window.
3. Ms. A refused to reimburse B Ltd.
4. B Ltd. commenced legal action against Ms. A to obtain payment.
5. In an out-of-court settlement, Ms. A made a payment to B Ltd. in the amount of the cost incurred to repair the damaged window, which B Ltd. accepted in full satisfaction of its claim against Ms. A and released Ms. A from any further liability.

Decision

The payment by Ms. A to B Ltd. is not subject to GST/HST.

Rationale

The payment is not consideration for a taxable supply. It is in essence compensatory. The payment represents compensation for the damage to B Ltd.'s display window and is meant to restore, to some degree, B Ltd. to the position it was in prior to the damage occurring.

Subsection 182(1) does not apply, since one of the requirements for subsection 182(1) is that there must be a prior agreement between the parties for the making of a taxable supply. In this situation, there was no agreement between the two parties for the making of any supply.

EXAMPLE NO. 7

Facts

1. Qco, a registrant, was using a particular trading name and style of logo for some time (Info-Link).
2. Qco became aware that another company (Rco), a registrant, had applied to the appropriate authorities to register a similar trading name and logo, and that this could potentially be damaging to Qco's business.
3. Qco began legal proceedings against Rco.
4. As a result of an out-of-court settlement, Rco made a payment to Qco, in exchange for Qco's agreement to change its name to Zco and not to use the word "Info-Link" or anything similar in the future.

Decision

The payment by Rco to Qco relating to the name change is subject to GST/HST.

Rationale

Subsection 182(1) does not apply, since there was no prior agreement for the making of a taxable supply. However, the payment by Rco to Qco is subject to GST/HST under subsection 165(1), because it was made to obtain the change in name by Qco and Qco's agreement to discontinue the use of the name "Info-Link" in the future.