

# GST Treatment of Out-of-Court Settlements: Is There a Forbearance to Sue?

| by Ivy Ling Yieng Ping |

It is common for parties to settle a contractual dispute out of court by way of a settlement agreement. Such an agreement would involve one party (A) paying the other (B) in full and final settlement of the dispute. To make sure the dispute is “over”, a typical settlement agreement would also state that, B, in return for the payment made by A, would release A from any and all claims B has against A. On the assumption that both parties are GST registered, a question would then arise as to whether the payment made by A to B in order to settle the dispute amounts to consideration for a supply made by B. If the answer is in the affirmative, then GST must be accounted for.

Although there is as yet no Malaysian case law on this point, references can be made to the positions adopted by countries such as New Zealand and Australia, and their relevant precedents, in this respect. In September 2002, New Zealand published its own interpretation statement regarding the GST treatment of court awards and out-of-court settlements.<sup>1</sup> More than a year earlier, in June 2001, the Australian Taxation Office had issued a ruling<sup>2</sup> on the GST consequences of court orders and out-of-court settlements.

This article seeks to examine the positions taken by the above jurisdictions and how the drafting of a settlement agreement could affect the GST treatment of payment received out of a settlement agreement. Before turning to the respective positions adopted by New Zealand and Australia, it is imperative to set out the basic concept of GST.

## A tax on ‘supply’

GST is essentially a tax on supply. Section 9(1)(a) of the Goods and Services Tax Act 2014 (“GST Act”) provides that GST shall be chargeable on any supply of goods or services made in Malaysia, including anything treated as a supply under the GST Act. Further, s 9(2) provides that GST is chargeable on any supply of goods or services made in Malaysia, where it is a taxable supply made by a taxable person in the course or furtherance of any business carried on by him.

## Liability of the supplier

Pursuant to s 9(3) of the GST Act, GST is the liability of the person making the supply and, as a general rule, becomes due and payable at the time of supply. Thus, if it is concluded that A makes the settlement payment in return for a supply of services from B, then B as the supplier needs to account for GST on the payment received from A.

Where a typical settlement agreement between A and B includes a clause to the effect that B would forbear to sue in the future, such a clause may suggest a supply from a GST perspective. However, for a supply to be taxable, it must first be made in the course or furtherance of a business.

## Meaning of ‘business’

Business is generally and widely defined under s 3 of the GST Act so as to include any trade, commerce, profession, vocation or any other similar activity, whether or not it is for a pecuniary profit.

Section 3(3) treats anything done in connection with the commencement, termination or intended termination of a business as being done in the course or furtherance of that business.

Based on the provisions above, where court litigation arises out of a contractual dispute between two GST-registered persons (A and B), it can be safely concluded that a supply made by B (if any) is done so in the course or furtherance of his business.

1 Interpretation statement IS3387, “GST treatment of court awards and out of court settlements”, by the New Zealand Inland Revenue <<http://www.ird.govt.nz/resources/9/b/9b8a5e804ba38347a5fdbd9ef8e4b077/is3387.pdf>>  
2 Goods and Services Tax Ruling 2001/4

### Meaning of 'supply'

Supply is defined under s 4(1) of the GST Act to mean all forms of supply, including supply of imported services, done for a consideration and anything which is not a supply of goods but is done for a consideration is a supply of services. Based on the definition of supply under s 4(1), as a general rule, a transaction will only fulfil the meaning of supply under s 4(1) if it is done for consideration, unless it is a business transaction entered into between connected persons.<sup>3</sup>

Although supply is defined to be "all forms of supply", this does not include "anything" and "everything" under the sun. It is a "supply" if it can, apart from s 4 of the GST Act, be considered an act of supplying according to the meaning of the word "supply" at common law.

In the UK cases of *Carlton Lodge Club v Customs and Excise Commissioner*<sup>4</sup> and *Customs and Excise Commissioners v Oliver*,<sup>5</sup> the term "supply" has been held to mean its ordinary and natural meaning, being "to furnish or to serve" or "to furnish or provide". The fact that "to supply" means "to furnish or to serve" implies there to be another party to whom the goods or services are furnished, and also an agreement between that person and the supplier under which the goods or services are furnished or served. New Zealand adopted a similar definition in *C of IR v Databank Systems Ltd*.<sup>6</sup>

### Settlement agreement: Is there a supply?

Where the settlement agreement does not involve any moveable and immovable property, a supply of goods can be discounted. The more pertinent question would be whether there is a supply in the form of a service from B to A in return for the payment from A as "consideration".

Section 2 of the GST Act defines "services" as:

"... anything done or to be done including the granting, assignment or surrender of any right or the making available of any facility or benefit but excludes supply of goods or money".

### Forbearance to sue can be a 'service'

It is apparent from the definition that "service" is sufficiently wide to cover an act of giving up a person's right including a promise not to pursue a legal claim against another person, i.e. forbearance to sue — a promise that B shall not pursue a claim against A in respect of the same in future.

However, in order for a forbearance to sue to qualify as a supply of services, it must be given in return for a consideration.

### Does payment received constitute consideration'?

Section 2 of the GST Act defines the term as follows:

"consideration" in relation to the supply of goods or services to any person, includes **any payment made or to be made**, whether in money or otherwise, or any act or forbearance, whether or not voluntary, **in respect of, in response to, or for the inducement of, the supply of goods or services**, whether by the person or by any other person..."  
(*emphasis added*)

From the definition above, consideration under the GST Act includes monetary and non-monetary payments. However, that payment (whether monetary or otherwise) must be made in respect of, in response to, or for the inducement of the supply of goods or services. This is in pari materia with the definition of consideration adopted by New Zealand under s 2 of its Goods and Services Tax Act 1985. Although currently there is no Malaysian precedent on point, both New Zealand and Australian case law support the proposition that there must be a sufficient nexus/connection between the payment in question to an identified supply.<sup>7</sup> The mere presence of a payment does not naturally constitute consideration under the GST Act and does not automatically attract GST.<sup>8</sup>

3 See para 2 of Schedule 3 to the GST Act for the meaning of "connected persons". Paragraph 6 of the First Schedule explicitly deems any supply of services for no consideration between connected persons as a supply for the purposes of GST.

4 [1974] 3 All ER 798 at 801

5 [1980] 1 All ER 353 at 354-355

6 (1989) 11 NZTC 6,093

7 See the New Zealand cases of *C of IR v New Zealand Refining Co Ltd* (1997) 18 NZTC 13,187 ("NZ Refining") and *Taupo Ika Nui Body Corporate v CIR* (1997) 18 NZTC 13,147 (HC)

8 *NZ Refining*, *supra* n 7

## Nexus/connection between ‘consideration’ and ‘supply’

The relationship between a supply and consideration as provided in s 4 of the GST Act states that “all forms of supply, including... done for a consideration”. Read alone, s 4 arguably suggests the existence of enforceable obligations, be they written or oral, between supplier and recipient. Although this is not an absolute prerequisite to making a supply for consideration, the supply must arise from a contractual or reciprocal relationship between the supplier and the recipient — an arrangement that does not bind the parties in some way is not sufficient to establish a supply by one party to the other.

In *C of IR v New Zealand Refining Co Ltd*<sup>9</sup> (“*NZ Refining*”), the judge held that despite the wide definition of consideration, “there was a practical necessity for a sufficient connection between the payment and the supply”. The fact that there is a payment does not necessarily infer that it is made for a supply. Theoretically, a payment can be related to a supply but if the payment is not made for that supply, it will not be a consideration. Essentially, this is to say not all payments received by a business may be consideration for a supply.

The requirement for a contractual or reciprocal relationship between the supplier and the recipient was emphasised by the New Zealand Court of Appeal in *NZ Refining*.<sup>10</sup> That case concerned a series of payments made by the New Zealand government to the New Zealand Refining Company, pursuant to an agreement to release the government from an earlier undertaking to repay offshore loans totalling US\$125 million. The issue that arose was whether those payments were consideration for any supply made by the refinery company. In order to receive the payments, the refinery had to be operational on the date of payment, failing which the only recourse was to withhold payment.

The Court of Appeal noted there was an expectation among the parties that the refinery would continue to operate, but that there was no contractual obligation to that effect. The government’s only recourse in the event that the refinery ceased to be operational was to stop making payments. Although the payments were intended as an inducement to keep the refinery open, they were not linked to any identifiable supply:

“In our view the payments related to the structure or framework within which supplies of services were expected to be made. **They were to compensate NZRC [New Zealand Refining Co] for the removal of the protections given by the Support Letters and its exposure to the hotwinds of competition. It was compensation directed to the same purpose as the grants which repaid the loans. The payments were received in course of the taxable activity of NZRC but they were not in consideration for any supply made by it. Accordingly, they are not subject to GST.**” (*emphasis added*)

As can be seen from *NZ Refining*, a distinction needs to be drawn between a condition for payment and reciprocal obligations between parties. A nexus in the form of reciprocal obligations is required in order for a consideration to be made in return for a supply for GST purposes. A mere condition upon which payment will be made is insufficient to be consideration for a supply.<sup>11</sup>

## New Zealand position on forbearance to sue

In essence, the New Zealand Inland Revenue (“NZ Inland Revenue”) in Interpretation Statement IS3387 has taken the position that there would be no supply of forbearance to sue in situations where:

- (a) there is no separate and ascribable value attached to the forbearance to sue; and

9 *Supra* n 7

10 *Ibid*

11 *Supra* n 1, at pp 6-12

- (b) the forbearance is not given in return for a consideration as the consideration (i.e. the compensation) is linked to a loss or damage.

Although it is acknowledged that “forbearance to sue” is capable of being a supply of service under s 2 of the New Zealand Goods and Services Tax Act 1985, the NZ Inland Revenue’s view is that payment made under a settlement agreement is usually for something other than forbearance to sue, such as to compensate a loss or a damage. In such circumstances, forbearance to sue is merely a mechanism to ensure finality in a dispute.<sup>12</sup> Consequently, the forbearance is said to have been given for no consideration and thus no supply has been made by virtue of agreeing not to pursue a claim in the future.

The NZ Inland Revenue takes the view that for a supply to take place, something of value must be “furnished or provided”.<sup>13</sup> The supply must additionally involve an enforceable reciprocal obligation.<sup>14</sup> Where something is given in the form of compensation, the basis for the recipient to receive such compensation is the fact that he has suffered a loss rather than making any supply. On this premise, the compensation cannot be consideration in return for a supply.

In *Case S77*,<sup>15</sup> the District Court of New Zealand considered the issue of whether an amount received for damages could be consideration for any supply subject to GST. The taxpayers were a farming couple registered for GST. A fire they lit on their property spread to a neighbouring farm and caused substantial damage, leading to allegations of negligence which resulted in an out-of-court settlement. The taxpayers sought an input tax credit on the amount they paid and this was disallowed by the commissioner on the basis that the recipient of the payment made no taxable supplies in return. Barber DJ held that the transaction did not involve the supply of any goods and services to the taxpayers, as the payment was made on account of a loss:

“While I find that the L partners issued the court proceedings in the course of their taxable activity as agricultural contractors, **they have merely received payment of a liability of and from the objectors. The L partners made no supply in return of the payment. They merely received a debt due to them in recompense for the loss they suffered from the fire for which the objectors were responsible.**” (*emphasis added*)

*Case S77* emphasised the importance of the distinction between payments and receipts made in the course or furtherance of business and the requirement that these are linked to supplies in order for GST liability to arise. Loss may be suffered in connection with a supply. Where payments are compensatory, and relate to loss, the nexus is with the loss and not the supply that caused the loss. Accordingly, the compensation is given due to the loss suffered and not in return for a supply.

Further, based on *NZ Refining’s* case above, it is clear that if the purpose of payment is to compensate the loss suffered by B for the alleged breach of contract by A, then the payment (whether monetary or otherwise) is made for loss or damage; it would not be consideration for a supply as there is a complete lack of reciprocal relations between the parties in regard to the compensation. The very facts of *NZ Refining* arose consequent to the New Zealand government’s removal of various concessions enjoyed by the refinery company unilaterally and the Court of Appeal ruled that the payment to the refinery company was compensatory in nature with no GST liability attached as it was not made in return for an identifiable supply.

However, if there is a separate and ascribable value attached to the forbearance to sue, GST would be chargeable. The relevant example given is reproduced as follows:<sup>16</sup>

<sup>12</sup> *Supra* n 1, at p 29

<sup>13</sup> *Databank Systems Ltd*, *supra* n 6

<sup>14</sup> *NZ Refining*, *supra* n 7

<sup>15</sup> (1996) 17 NZTC 7,483

<sup>16</sup> *Supra* n 1, at p 30

### “Example

A and B are both GST registered. A causes B to lose thousands of dollars as a direct result of B relying upon A's negligent business advice. B believes that he has a solid case to take to court, but is persuaded by A to settle out of court as A wishes to avoid adverse publicity.

#### *Scenario #1*

The parties settle the claim for loss for \$10,000, and the settlement agreement includes a clause whereby B accepts the sum in “full and final settlement” of his claim against A.

- The GST consequences of the payment for loss are nil. The agreement not to sue is merely a mechanism in order for A to ensure finality in the dispute, and does not have a separately attributable sum ascribed to it.

#### *Scenario #2*

The parties settle the claim for loss for \$10,000, with an additional payment of \$5,000 by A to B in order for B undertaking to refrain from pursuing his claim by bringing the matter before the courts, as A believes his reputation would be seriously damaged by the resulting publicity.

- The GST consequences of the payment for loss are nil. The payment of \$10,000 is not payment for any supply.
- GST consequences do arise as a result of the \$5,000 payment as the payment is clearly made by A in return for the enforceable obligation undertaken by B in his agreement not to sue A. The payment is consideration for a taxable supply by B as B is accepting payment in the course of his taxable business activity. B must accordingly return output tax of \$650, and A will be able to claim an input tax deduction pursuant to Section 20(3).<sup>17</sup>

Based on the analysis above, the NZ Inland Revenue's position can be summarised thus: Where a payment is made by A as a form of compensation for the losses that B has allegedly suffered, there would be no supply made by B in return for the payment. However, if A's payment is reciprocal and directly linked to forbearance to sue, that is to say by not proceeding with its claim for damages against A, B receives the settlement payment in return, then B, as the supplier, needs to account for GST on the payment received from A.

### **Australian approach to out-of-court settlement and ‘forbearance to sue’**

The Australian Taxation Office (“ATO”) in its Goods and Services Tax Ruling 2001/4 takes the view that the following conditions of settlement can create supply for the purpose of GST:

- (a) Surrendering a right to pursue further legal action; or
- (b) Entering into an obligation to refrain from further legal action; or
- (c) Releasing another party from further obligations in relation to the dispute

and these supplies are referred to as “discontinuance supplies”.<sup>17</sup>

Similarly, the ATO takes the position that the discontinuation of a court action is a “discontinuance supply” which does not have a separately ascribed value and is merely an inherent part of the legal machinery to add finality to a dispute. The discontinuance of court actions does not give rise to additional payment in its own right.<sup>18</sup> Accordingly, it does not normally give rise to a supply as they are in the nature of a term or condition of the settlement rather than the subject of a settlement.<sup>19</sup>

In addition, the ATO also takes the view that the inclusion of “no liability” clauses which are commonly included in settlement agreements does not affect the position it has taken.<sup>20</sup> However, such payment may have a nexus

17 *Supra* n 2, para 54

18 *Ibid*, para 107

19 *Ibid*

20 *Ibid*, para 108

with a “discontinuance supply”, if there is overwhelming evidence that the subject of the dispute is so lacking in substance that the payment could have only been made for a discontinuance supply.<sup>21</sup> Australia took the position that there may be instances where the payment received in a settlement agreement is not in return for discontinuance supply, but is in relation to an earlier supply<sup>22</sup> or current supply.<sup>23</sup> On the one hand, if the payment made under a settlement agreement is in relation to an earlier supply made under the contract, the GST accounted for the earlier supply would have to be adjusted (upwards or downwards) according to the facts of the case; but on the other, if the payment made under a settlement agreement is in relation to a current supply, meaning a new supply (any supply other than a discontinuance supply) created by the terms of the agreement, the payment would be consideration for the current supply if there is sufficient nexus.

If the payment under a settlement agreement is compensatory and there is no earlier or current supply, the payment would not be consideration for a supply and no GST would be payable in Australia. In *Shaw v Director of Housing & Anor (No 2)*,<sup>24</sup> Underwood J decided that the plaintiff was entitled to recover damages from the defendants for negligent misstatement. The parties were unable to agree whether the plaintiff would incur liability to pay GST as a result of payment of the judgment sum in accordance with the provision of A New Tax System (Goods and Services Tax) Act 1999, and if the plaintiff were so liable, whether that liability would be part of his loss and thus recoverable from the defendants.

In deciding whether any GST was payable by the plaintiff, Underwood J held that:

“12. The provisions of the Act, s 9-10(2) are not exhaustive. They are merely instances of the general proposition enacted by s 9-10(1) which defines “supply” as “any form of supply whatsoever”, but as the judgment sum will be damages for negligent misrepresentation, **I am unable to conceive of any**

**possible supply by the plaintiff upon receipt of the judgment sum other than the release of the obligation to pay that sum as referred to in s 9-10(2)(g).**

...

“17. In recent times a release commonly means a discharge of a right of action, claim or demand made by one person upon another or others. A release is enforceable if it is given under seal or is supported by consideration. See, eg, *McDermott v Black* (1940) 63 CLR 161. It is the releasor’s entry into the deed or agreement that extinguishes the claim or demand. See *Bowes v Foster* (1858) 2 H & N 779 at 782; 157 ER 322 at 323. Again, such a release could not be entered into without voluntary action upon the part of the releasor.

“18. The obligation of the judgment debtor to pay the judgment sum is extinguished by the act of payment. The extinguishment or release does not depend upon any action on the part of the judgment creditor...

...

“It was held in *Databank Systems Ltd v Commissioner of Inland Revenue (NZ)* (1987) 9 NZTC 6213 that “supply” means “to furnish or provide”. **Application of that proposition to the word “supply” as enacted in the Act, s 9-10 reinforces the concept that there is a legislative intention not to include in the word “supply” the release of an obligation that occurs independently of the act of the releasor. (emphasis added)**

“20. For those reasons I am not persuaded that upon the defendants making payment of the judgment sum the plaintiff will make a supply within the meaning of the Act, s 9-10 and consequently be liable to pay GST. Further, I am unpersuaded that there is a substantial risk that that will be the case. ...”

21 *Ibid*, para 109

22 *Supra* n 2, paras 102-104

23 *Ibid*, para 105

24 [2001] TASSC 2

## The takeaway: Wording of settlement agreement

It is apparent that the wording of a settlement agreement plays a vital role in ascertaining whether the payment is made by A to compensate B or is made by A in return for B's promise not to pursue any further claim.

In determining whether GST is payable, if the settlement agreement shows that A makes payment with the view of compensating any alleged loss suffered by B, it can be safely concluded that B is not required to account for GST on the payment received. However, it is very common to see a standard clause of a settlement agreement worded thus:

"The parties hereto agree as follows:

1. Release and Discharge  
**In consideration of A's agreement to make payments herein, B completely releases and forever discharges A** of and from any and all past, present or future claims, demands, obligations, action, cause of action, rights, damages, costs, loss of services, expenses and compensation which B now has, or which may hereafter accrue or otherwise acquired by B, on account of...
2. Consideration  
**In consideration of the release set forth above, A hereby agrees to pay B RMxxx..."**

This is a classic example where a separate and ascribable value has been attached to a "forbearance to sue" and, consequently, would be required to pay GST out of the payment received. The amount of GST accountable by B will be determined in accordance with the rules of valuation stipulated under s 15 of the GST Act. If the

payment is wholly monetary, B has to account for GST based on the tax fraction of 6/106 on the payment it has received. In other words, the net sum received by B under the settlement agreement would be 6% less than what he would have expected to receive, while A is entitled to deduct input tax credit pursuant to sections 38 and 39 of the GST Act.

If payment is made by A with the view of compensating the alleged loss suffered by B, the drafting of the settlement agreement should reflect this. A "no liability" clause can be included to prevent any admission of liability on the part of A. The wording of the clause and the manner in which a settlement agreement is drafted are the primary evidence for the purpose of which A makes a payment to B. Consequently, if the terms of the settlement agreement do not reflect the true purpose of a settlement payment, the party receiving the payment — in this case, B — would end up paying GST out of his own pocket.

With the implementation of GST in Malaysia, it is inevitable that the drafting of a settlement agreement would now have to take into account any potential GST implications. Accordingly, taxpayers, especially those entitled to payment in full and final settlement of a dispute, should be mindful of the wording used in a settlement agreement to ensure that their commercial interests are protected at all material times.

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