

## *Tax and settlements*

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### 1. Introduction

1. This paper looks at the impacts of Federal taxes on litigation settlements.
2. The main areas covered by the paper are:
  - (1) Goods and Services Tax (**GST**) and settlements;
  - (2) Income tax (including capital gains tax) and settlements; and
  - (3) Superannuation death benefits.

### 2. GST and settlements

3. In order to understand the GST impact on settlements, it is first necessary to understand when GST is imposed and upon whom.
4. The entity making a “taxable supply” is liable for the GST.<sup>1</sup> That is, if a business supplies goods to a customer then it is the business that is liable to remit the GST to the Australian Taxation Office (**ATO**), not the customer. For taxable supplies, the GST is, generally, one eleventh of the purchase price.<sup>2</sup>
5. An entity makes a “taxable supply” if:
  - (1) The supply is made for consideration;
  - (2) The supply is made in the course or furtherance of an enterprise that the entity carries on;
  - (3) The supply is connected with Australia; and
  - (4) The entity is registered or required to be registered.<sup>3</sup>
6. GST-free and input-taxed supplies are not liable for GST.
7. One of the requirements is that there be a supply made “for” consideration. This requires a sufficient nexus between the consideration and the supply.
8. Consideration includes not only payments, but also any act or forbearance in connection with a supply of anything or in response to or for the inducement of a supply of anything.<sup>4</sup> There is a provision in the GST Act which states that it does not matter whether the payment, act or forbearance was in compliance with an order of a court, tribunal or other body that has the power to make orders; or whether it was in compliance with a settlement related to proceedings before such a court, tribunal or other body.<sup>5</sup>

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<sup>1</sup> s 9-40, *A New Tax System (Goods and Services Tax) Act 1999* (Cth) (**GST Act**).

<sup>2</sup> See Subdivision 9-C, Division 9, Part 2-2, GST Act.

<sup>3</sup> s 9-5, GST Act.

<sup>4</sup> s 9-15(1), GST Act.

<sup>5</sup> s 9-15(2A), GST Act.

9. A supply is any form of supply whatsoever.<sup>6</sup> There is a non-exhaustive list of supplies in the legislation which includes, amongst other things:

- (1) A supply of goods or services;
- (2) A creation, grant, transfer, assignment or surrender of any right;
- (3) An entry into, or release from an obligation to do anything, to refrain from an act, or to tolerate an act or situation.

10. This paper will now consider the GST treatment of settlements.

*Different classifications of settlements by the ATO*

11. There are at two initial issues in determining the impact that GST has on a settlement:

- (1) Whether the settlement involves a supply for consideration;
- (2) If it does not, whether GST will, nonetheless, have an impact on the appropriate amount of the settlement.

12. Even if the settlement does involve a supply for consideration, that does not automatically mean that GST is payable. The other requirements, outlined above, for a taxable supply must also be met before GST will be imposed. That is, the supply must be made in an enterprise and the supplier must be registered or required to be registered for GST.

13. If one of the parties is not registered or required to be registered for GST, then that may impact on the GST treatment of the settlement payment. Assuming the settlement results in a payment from the defendant to the plaintiff, then there are a number of possible scenarios that may arise, including:

- (1) if both parties are not registered or required to be registered, then there should be no GST impact. There will also be no GST;
- (2) if both parties *are* registered for GST, then there may be GST payable if the settlement results in a taxable supply. If, however, the defendant (the payer of compensation) is making acquisition in carrying on their own enterprise, then they may be entitled to an input tax credit for the GST component of the settlement payment.<sup>7</sup> This would result in a neutral GST treatment (i.e. although part of the settlement payment represents GST that the plaintiff must remit to the ATO, the defendant can claim that component back as a credit);
- (3) assume the plaintiff (the supplier) is registered for GST, but the defendant (the payer) is not registered for GST. If the settlement results in a taxable supply then GST will be remitted by the plaintiff to the ATO, however, the defendant will not be able to claim any input tax credit for the GST component of the settlement payment.

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<sup>6</sup> s 9-10(1), GST Act.

<sup>7</sup> See Division 11, GST Act.

14. The ATO has released a ruling on the GST treatment of settlements (*GSTR 2001/4*). In that ruling, the ATO classifies the GST treatment of settlement payments along the following broad lines:

- (1) Where there has been a supply already;
- (2) Where the settlement itself constitutes/results in a new supply;
- (3) Where the supply essentially involves the ending of the legal action (the ATO terms this a discontinuance supply).

*Earlier supplies*

15. Legal action may be brought in respect of a supply of goods or services that has already occurred. For example, a business may provide goods to a customer and the customer fails to make payment. The supplier may bring legal action to recover the price of those goods. If the legal action is settled then the settlement would, generally, constitute consideration for the earlier supply and GST would therefore be payable in respect of the settlement payment.

16. This treatment could even extend to a claim for quantum meruit based on previous services that had been provided by the plaintiff to the defendant: see, for example, *Adamson v Ede* [2008] NSWSC 767.

17. A settlement relating to an earlier taxable supply can result in adjustments to the GST payable. Assume that Supplier A accounts for GST on an accruals basis (as opposed to accounting on a cash basis) with monthly tax periods. The GST payable by an accruals taxpayer is attributable to the earlier of the tax period in which any consideration is received for the supply and the tax period in which a tax invoice is issued.

18. Supplier A carries on a manufacturing business and supplies electronic signs to Customer B in January 2017. A tax invoice is also issued in January 2017 for a price of \$110,000 including GST (i.e. GST of \$10,000). As Supplier A is an accruals taxpayer, it will be required to attribute the GST to the January 2017 tax period. It remits the GST to the Commissioner.

19. Customer B fails to pay and Supplier A files proceedings in court to recover the purchase price. They eventually settle the matter and agree, in the settlement deed, upon a payment of \$99,000 which is made in September 2017.

20. The settlement payment is consideration for the earlier supply of the electronic signs. The GST payable to the ATO will be \$9,000. As greater GST of \$10,000 has already been remitted to the ATO, a GST adjustment will be required.

*Current supplies*

21. There may be instances where the settlement itself results in a supply being made and the settlement payment is sufficiently connected with that supply. In that scenario, if the supplier (whether plaintiff or defendant) is registered or required to be registered for GST and the supply is made in the course or furtherance of their enterprise, then the settlement payment will be subject to GST.

22. It may be prudent for the settlement deed to require the person receiving the payment (usually the plaintiff) to provide a tax invoice to the payer of the settlement payment. This enables the payer to claim an input tax credit for any GST payable provided that they are registered for GST and they are making an acquisition of something in carrying on an enterprise.
23. If it is not clear whether a settlement results in a supply then it may be prudent to include a GST gross-up in the settlement deed so that, in the event that GST is payable, the defendant is required to make an additional payment for the GST. This would also be desirable if it is unclear whether the supply is input-taxed or GST-free (in which case no GST would be payable).
24. *Australian Style Investments Pty Ltd as trustee for the Australian Style Investments Unit Trust and Commissioner of Taxation* [2013] AATA 847 provides a good illustration of why this would be a prudent course of action.
25. The case involved a taxpayer that held units in 2 unit trusts which had been established as managed investment funds to be used to carry out the Brisconnections infrastructure project in Queensland. The units were listed on the ASX but carried latent liabilities for unit holders to provide additional capital contributions to the trusts. Many individual unit holders were not aware of these latent liabilities when they purchased the units.
26. The taxpayer managed to garner sufficient support to requisition meetings of the trusts' unit holders to consider and vote on a number of resolutions including one to wind up the trusts.
27. The taxpayer eventually entered into a settlement deed with two of the companies interested in the project (Thiess Pty Ltd and John Holland Pty Ltd). The settlement deed provided for a flat \$4.5m payment from those companies to the taxpayer. The taxpayer was required to, amongst other things, provide proxies to those companies for the meetings of unit holders and to refrain from taking any action to support the resolutions at the meetings.
28. There was no GST gross-up clause in the agreement. The taxpayer lodged a business activity statement after the payment was made and did not disclose any GST liability on the settlement payment. The ATO subsequently conducted an audit and issued an assessment for the GST on the payment on the basis that there had been a taxable supply by the taxpayer (i.e. the \$4.5m payment was connected to that supply).
29. The taxpayer challenged the assessment before the Administrative Appeals Tribunal on the basis that the supply was a financial supply and so was input-taxed and not subject to GST. The Tribunal upheld the ATO's assessment.
30. The consequence was that the taxpayer was liable for GST and was not entitled to claim any additional amount from Thiess Pty Ltd and John Holland Pty Ltd because there was no GST gross-up clause in the settlement deed.

*Discontinuance supplies*

31. Finally, the ATO considers that a settlement of court or tribunal proceedings may, in most cases, result in a supply because a plaintiff would generally release a defendant from the existing claims and any further claims and obligations (and sometimes there will also be mutual releases). This can result in a supply constituting a surrender of the right to continue legal action; or a supply that constitutes entering an obligation to refrain from further legal action; or a supply constituting a release of a party from further obligations relating to the dispute.
32. The ATO terms such supplies as “discontinuance supplies”. The ATO considers that, usually (but not always), a settlement payment will not relate to discontinuance supplies and so the discontinuance supplies will not attract GST. The ATO view is that a settlement payment would only have a sufficient nexus with a discontinuance supply such as to give rise to a GST liability if there is overwhelming evidence that the settled claim is so lacking in substance that the payment could only have been made for the discontinuance supply.
33. A court order will not result in a discontinuance supply.

*Damages not relating to a supply and issues with quantum*

34. There are cases where a settlement will not relate to a supply of anything. For example, settlement sums for damages for a termination or breach of contract; for personal injuries; for property damage; for breach of copyright; and negligence resulting in lost profits would not result in a supply.<sup>8</sup>
35. No GST would be payable on such a settlement payment as there has been no supply.
36. GST can, however, still be relevant to the quantum of damages which the parties agreed to settle on. The impact of GST on damages is illustrated by *Millington v Waste Wise Environmental Pty Ltd* [2015] VSC 167. This was a test case run by the author for Insurance Australia Group dealing with damages principles in their interaction with tax, specifically, GST.
37. The case involved an award of damages by the Magistrates’ Court for expenses incurred in repairing a garbage truck involved in a traffic accident caused by the driver of a car. The car was insured and the insurance company agreed to indemnify the driver for his liability arising from the accident. The garbage truck was used in the plaintiff’s business and was damaged in the course of that business. The plaintiff was also registered for GST. It incurred repair costs which included GST.
38. The Magistrate found that the plaintiff’s loss and damage included GST on the repair costs (despite the plaintiff being able to claim input tax credits for that GST). The Magistrate also found that the plaintiff was under a positive duty to mitigate its loss by claiming input tax credits for the GST. Finally, the Magistrate made an order awarding the GST inclusive amount as damages but with an order that there be a subsequent repayment of an amount equal to the input tax credits which the plaintiff was entitled to claim.

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<sup>8</sup> See *GSTR 2001/4*, paragraphs 71 to 73.

39. The matter was appealed to the Supreme Court. The Supreme Court set aside the Magistrate's orders. Amongst other things, the Court found that the correct measure of damages was the GST *exclusive* amount of the repair costs. The award of damages properly calculated should not have included the input tax credits which were claimable by the plaintiff. Further, as the amount of input tax credits claimable was certain and fixed, there should have been a single award of damages without an order for a subsequent repayment of an amount equal to the input tax credits once claimed.
40. Accordingly, if a dispute relating to underlying loss or damage is being settled then the defendant should consider whether the plaintiff is entitled to any input tax credits for the loss or damage (eg expenses incurred in rectifying the damage). This could impact on the amount for which the dispute is settled.

#### *Apportionment*

41. The ATO takes the view that if a settlement payment is sufficiently connected to multiple supplies then it may be necessary to apportion that payment (eg if there are some taxable supplies and some GST-free or input taxed supplies which are not subject to GST). An apportionment would also be required if part of the settlement payment related to damages for which there was no supply and part related to supplies.
42. If the settlement terms actually dissect the payment then the apportionment would simply be based on that dissection, provided it was done on a reasonable basis.
43. An apportionment is still required even if the settlement terms do not dissect the payment. The ATO may impose their own apportionment where they consider that an apportionment is not reasonable.

#### *Judgments*

44. A court does not, when giving judgment, make a supply for GST purposes.<sup>9</sup> Similarly, the payment of a judgment debt also does not result in a supply.

#### *Costs and judgment interest*

45. A mere payment/reimbursement of legal costs in a settlement does not result in any taxable supply. This is because the payment of costs is not consideration for any supply by the entity that has incurred the costs to the payer.<sup>10</sup>
46. Legal costs, generally, would have a GST component. The key issue is therefore whether the entity incurring the legal costs will be able to claim input tax credits for those costs. They should, generally, be able to claim input tax credits if the costs are incurred in carrying on an enterprise and they are registered for GST.

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<sup>9</sup> See *Interchase Corporation v ACN 010 087 573 Pty Ltd & Ors* [2000] QSC 13; *Shaw v Director of Housing and State of Tasmania (No 2)* [2001] TASSC 2; *Walter Construction Group Ltd v Walker Corporation Ltd & Ors* [2001] NSWSC 283; *GSTR 2001/4*, paragraphs 56 to 67.

<sup>10</sup> See *GSTR 2001/4*, paragraph 148.

47. If input tax credits are claimable, that may impact on the amount of the settlement. Parties should consider, for example, agreeing a lower settlement for legal costs where the party that has incurred those costs can claim input tax credits. Contrast that with a situation where there is no entitlement to input tax credits or it is not clear whether they could be claimed: see *Vrkic v Otta International* [2003] NSWSC 641.
48. The same treatment would not, necessarily, result if the matter did not settle and the court awarded costs: see *The Beach Retreat Pty Ltd v Mooloolaba Yacht Club Marina Ltd* [2009] QSC 84; *Hennessey Glass and Aluminium Pty Ltd v Watpac Australia Pty Ltd* (2007) 69 ATR 374; *ChongHerr Investments Ltd v Titan Sandstone Pty Ltd* [2007] QCA 278.
49. Payment of judgment interest does not constitute consideration for a supply and so no GST will be payable in respect of such a payment. Pre-judgment interest also does not have a GST impact.<sup>11</sup>

#### ***Insurance and family breakdowns***

50. There are special rules that govern insurance settlements in Division 78 of the GST Act. A consideration of those rules is beyond the scope of this paper.
51. *GSTR 2003/6* sets out the ATO's views on the application of GST to transfers of business assets between spouses as a result of a matrimonial property distribution under the *Family Law Act 1975* (Cth). A consideration of that ruling is also beyond the scope of this paper.

### **3. Income tax and settlements**

52. This section will examine the impact of income tax, including capital gains tax (CGT), on settlements. The key issue here is the drafting of the settlement terms. In most, but not all, cases it will be better to draft the settlement terms in a way that specifically identifies each head of compensation and the amount that is being allocated to that head (eg interest, costs, lost profits). There may be some cases, however, in which, due to different tax treatments of income and capital, this could result in a less beneficial tax outcome than if an undissected lump sum is specified as the amount of compensation (see further below).
53. In some scenarios, an amount subject to the CGT provisions may receive a more favourable tax treatment than income due to:
  - (1) The 50% discount for individuals and trusts in respect of CGT assets that have been held for at least 12 months (or 1/3 for superannuation funds)<sup>12</sup>, or other similar discounts/concessions for small business assets<sup>13</sup>;
  - (2) An asset being acquired prior to 20 September 1985 (i.e. pre-CGT). Such an asset will not, on disposal, be subject to CGT;

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<sup>11</sup> See *GSTD 2003/1*.

<sup>12</sup> See Division 115, *Income Tax Assessment Act 1997 (ITAA97)*.

<sup>13</sup> See Division 152, *ITAA97*.

- (3) The main residence exemption from CGT for a house that is the main residence of an individual;<sup>14</sup>
- (4) Capital gains are disregarded if they are from a CGT event that relates directly to compensation or damages received for any wrong or injury suffered in the recipient's occupation or any wrong, injury or illness the person or their relate suffers personally.<sup>15</sup> This means, for example, that compensation payouts for personal injuries will often escape taxation if on capital account.
54. Accordingly, it is important to determine whether an amount is likely to constitute income or be subject to the CGT provisions because it may alter the tax outcome. The distinction between income and capital is discussed further below. It is also important to note that, unlike a revenue loss, a net capital loss can only be offset against capital gains, but not other assessable income.
55. If something is taxable as both income and under the CGT provisions, there are double tax provisions that reduce the capital gain to the extent that the amount is otherwise included in assessable income.<sup>16</sup>
56. If a settlement deed does not break down the compensation payment and allocate it between its constituent parts, then such an undissected lump sum is treated as capital.<sup>17</sup> The ATO, however, treats this as an amount for the disposal of the right to compensation, that is, the right to sue, which can have tax implications (see further below). The ATO is also willing to look beyond the settlement deed itself and may apportion a sum that is not dissected in the settlement deed if the facts and circumstances surrounding the receipt of compensation enable an apportionment.<sup>18</sup> For example, assume a party sent an offer of compromise in which the settlement sum was dissected and that offer was accepted. If the amount of the offer corresponds with the undissected amount in the settlement deed, the ATO may use the terms of the offer to apportion the compensation between different claims.

***What is the difference between income and capital receipts?***

57. Whether an amount of compensation is income or capital depends on its character in the recipient's hands and the method of calculation does not necessarily reflect this character.<sup>19</sup>
58. It is difficult to define income but generally it includes amounts that are earned and expected (eg income from personal services or derived from property investment) and often of a periodic, recurrent or regular character. Capital receipts are often lump sum payments or one-off payments that are made once and for all. Just because a payment is made as a lump sum, however, does not necessarily mean it is of a capital nature.

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<sup>14</sup> Subdivision 118-B, ITAA97.

<sup>15</sup> s 118-37(1), ITAA97.

<sup>16</sup> s 118-20, ITAA97.

<sup>17</sup> *McLaurin v FCT* (1961) 104 CLR 381.

<sup>18</sup> See *TR 95/35*, paragraph 190.

<sup>19</sup> See *FCT v Slaven* (1984) 15 ATR 242 and *Tinkler v FCT* (1979) 10 ATR 411.



59. Compensation payments, generally, have the same characterisation as the amount which they are intended to replace.<sup>20</sup> This means that compensation for lost income is, generally, treated itself as having the character of income.<sup>21</sup> For example, compensation for lost wages would constitute income itself.

### ***Basic CGT***

60. A basic understanding of CGT may assist in understanding the ATO's treatment of compensation for CGT purposes.
61. CGT is merely a part of the income tax provisions. The CGT provisions set out certain CGT events that may happen to a taxpayer's CGT assets. If such an event happens, the taxpayer is required to calculate their capital proceeds from the CGT event and their cost base for the CGT asset (or a reduced cost base if a capital gain is not made). If the capital proceeds exceed the cost base then the excess is a capital gain from that event. If the capital proceeds are less than the reduced cost base a capital loss is made.<sup>22</sup>
62. The taxpayer is required to work out all of their capital gains and capital losses for a particular income year and the losses are used to reduce the capital gains. Those reduced amounts are then reduced further by any carry-forward net capital losses and reduced by any discounts or other concessions (eg the 50% discount mentioned above). The remaining capital gains are added together to give a net capital gain which is included in the taxpayer's assessable income.<sup>23</sup>
63. Capital gains are calculated based on capital proceeds and cost base. Capital proceeds are, broadly, money or the market value of property that a person receives or is entitled to receive in respect of the CGT event, with some potential modifications.<sup>24</sup> The cost base of a CGT asset consists of the following broad elements:<sup>25</sup>
- (1) The money paid or market value of any other property given to acquire the asset;
  - (2) Incidental costs incurred to acquire a CGT asset or related to a CGT event (eg accounting or legal fees relating to the disposal of an asset);
  - (3) Costs of owning the CGT asset (eg interest, maintenance costs, rates, land tax etc);
  - (4) Capital expenditure incurred the purpose or the expected effect of which is to increase or preserve the asset's value or that relates to installing or moving the asset;
  - (5) Capital expenditure incurred to establish, preserve or defend title to the asset or a right over the asset.
64. The application of CGT depends on a CGT event having occurred. The most relevant events for compensation claims include:

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<sup>20</sup> See, for example, *FCT v Dixon* (1952) 86 CLR 540.

<sup>21</sup> See, for example, *FCT v Inkster* (1989) 24 FCR 53 and *Tinkler v FCT* (1979) 40 FLR 116.

<sup>22</sup> See s 100-15 and s 100-35, ITAA97.

<sup>23</sup> s 102-5, ITAA97.

<sup>24</sup> s 116-20 and s 116-25, ITAA97.

<sup>25</sup> s 110-25 and s 110-35, ITAA97.

- (1) Disposal of a CGT asset (event A1);<sup>26</sup>
- (2) Loss or destruction of a CGT asset (event C1);<sup>27</sup>
- (3) The ending of the ownership of an intangible asset by a number of means including by the asset (event C2):<sup>28</sup>
  - a. Being redeemed or cancelled;
  - b. Being released, discharged or satisfied;
  - c. Expiring;
  - d. Being abandoned, surrendered or forfeited; or
  - e. By an option or convertible right being exercised or converted;
- (4) Creation of rights (event D1).<sup>29</sup> This may be relevant where new rights are created in return for compensation.

65. It is important to have a basic understanding of these CGT events as their application can affect the analysis of how compensation receipts will be treated.

#### *ATO's approach to CGT and settlements*

66. The ATO's approach to CGT and compensation payments is set out in Taxation Ruling TR 95/35. Three of the main characterisations considered in the ruling are where:

- (1) The compensation is for the disposal of an underlying asset or part thereof;
- (2) The compensation is for permanent damage to, or a permanent reduction in the value of, an underlying asset;
- (3) The compensation is for disposal of the right to seek compensation (i.e. the right to sue).

#### *Underlying asset approach*

67. The ATO accepts that if the compensation receipt can be linked to the disposal of an underlying asset then the compensation receipt will take that character.<sup>30</sup> The ATO requires a direct and substantial link with the underlying asset.

68. This approach can have some advantages for taxpayers in respect of capital receipts. For example, assume that a taxpayer owns pre-CGT land that is compulsorily acquired by a government authority. Compensation is paid for the land acquisition.

69. Pursuant to the underlying asset approach, the compensation will be treated as consideration for disposal of the land. As the land is a pre-CGT asset, the disposal will not be subject to CGT.

70. Assume that this scenario is varied and the land is a post-CGT asset, but one that has been held for 12 months by an individual. Once again, the compensation is treated as consideration

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<sup>26</sup> s 104-10, ITAA97.

<sup>27</sup> s 104-20, ITAA97.

<sup>28</sup> s 104-25, ITAA97.

<sup>29</sup> s 104-35, ITAA97.

<sup>30</sup> See, for example, *Carborundum Realty Pty Ltd v RAlA Archicentre Pty Ltd and Graeme McDonald* (1993) 25 ATR 192.

for the disposal of the underlying land asset and, as that asset has been held for 12 months, the 50% CGT discount would be available.

71. In addition, if a replacement asset is purchased with the compensation, roll-over relief may be available for the capital gain.<sup>31</sup> If a compensation payment is received, the replacement asset must be purchased within one year before or after the CGT event. If it was used in a business (eg land used in a farming business), the replacement asset must either be used in that business for a reasonable time after it is acquired or must for that reasonable time be used for the same or a similar purpose to the purpose for which the original asset was used. The market value of the replacement asset must be more than the cost base of the original asset. There are particular roll-over concessions that are then available depending on how much is spent on the replacement asset.

*Compensation for permanent damage or reduction in value*

72. There may be situations in which a CGT asset is not disposed of but compensation is received for permanent damage or a reduction in value of the asset. For example, land that is contaminated by a chemical spill.
73. The ATO considers this to be a recoupment of acquisition costs of the asset. This means that there will be no CGT event on receipt of the compensation, but the cost base of the asset will be reduced. There is no CGT event even if the compensation exceeds the cost base. There will, however, be CGT consequences when the asset is eventually disposed of due to the reduction in cost base.

*Compensation for right to receive compensation*

74. If an amount of compensation cannot be sufficiently connected to an underlying asset then the ATO considers that it is for disposal of the right to seek compensation (i.e. the right to sue). That right to seek compensation will be acquired when the breach occurs giving rise to the right.
75. The cost base of the right to seek compensation would include, for example, legal costs incurred in commencing and prosecuting proceedings.
76. The right to seek compensation is disposed of on its release, discharge, satisfaction or surrender, for example, where this occurs by the terms of a settlement deed. The consideration for that disposal is then the settlement payment relating to that right.
77. Where there is an undissected lump sum, the ATO will also treat that as consideration for disposal of the right to receive compensation rather than the underlying asset. Apportioning compensation in a settlement deed can, therefore, have significant tax implications.
78. Take, once again, the scenario of a compulsory acquisition of pre-CGT land where there is a settlement between the parties. If the compensation is treated as an undissected lump sum then the ATO will treat it as consideration for the disposal of the right to receive

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<sup>31</sup> See Subdivision 124-B, ITAA97.

compensation, not the underlying asset. As the underlying asset is pre-CGT, its disposal would not be subject to tax in contrast with the disposal of the right to receive compensation.

79. Even an undissected lump sum settlement involving post-CGT land could have tax implications. For example, the replacement asset roll-over would be unlikely to be available – its conditions are unlikely to be met because the replacement asset would be land and the original asset would be the right to seek compensation. Similarly, if the right to seek compensation had not been held for 12 months then no CGT discount would be available on its disposal whereas the disposal of the underlying asset may have resulted in a CGT discount.
80. Taking another example, assume that there was an undissected settlement sum relating to claims for compensation for personal injuries and other claims not related to personal injuries or similar. If the compensation award was dissected in the settlement deed the compensation for personal injuries would likely be exempt from CGT.<sup>32</sup> If undissected, however, the requirements of the exemption would not be met.

*Undissected lump sums – when might capital treatment be advantageous?*

81. There may be some circumstances in which it is beneficial for settlement compensation to be an undissected lump sum and therefore treated as capital. For example, assume the settlement sum relates to both income and capital amounts. The income amounts would not, ordinarily, receive any CGT discount. If part of an undissected lump sum the whole amount would be treated as capital, that is, consideration for the disposal of the right to receive compensation. If the right to receive compensation has been held by an individual for at least 12 months then the 50% CGT discount may be available (whereas it would not otherwise have been available if the compensation was apportioned to the income amount).
82. Advisers must be mindful, however, of the general anti-avoidance provisions in Part IVA of the *Income Tax Assessment Act 1936* (Cth) if they attempt to engineer a particular tax outcome through a settlement deed.

***Costs***

83. Legal costs may be incurred in obtaining compensation. If those legal costs are deductible and are recouped as part of any compensation then the recouped amount will be treated as assessable income.<sup>33</sup>
84. If a capital gain is made (eg on disposal of the underlying asset or right to receive compensation), then the legal costs may be included in the cost base of the asset. If, however, the legal costs are recouped through part of the compensation payment then they cannot be included in cost base (unless they are otherwise included in assessable income).<sup>34</sup>

***Interest***

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<sup>32</sup> s 118-37, ITAA97.

<sup>33</sup> Subdivision 20-A, ITAA97.

<sup>34</sup> s 110-45(3), ITAA97.

85. Pre-judgment interest is, generally, treated as ordinary income and assessable as such. For personal injuries, however, pre-judgment interest is capital in nature.<sup>35</sup>
86. Post-judgment interest and other amounts of interest would, generally, be ordinary income and assessable as such. Post-judgment interest on a judgment debt relating to personal injuries is, however, exempt from income tax.<sup>36</sup>

#### ***Gross-up for taxation***

87. If the award of compensation is grossed-up to cover the cost of any taxation liability then the ATO treats that amount as additional consideration relating to the disposal of the underlying asset or the right to receive compensation. The additional amount will, therefore, be subject to taxation.
88. If, instead of an additional payment, a tax indemnity is given then the ATO treats the indemnity as a CGT asset (i.e. a right). The taxpayer receiving the indemnity is treated as having received any monetary payment plus the market value of the indemnity as consideration for the disposal of the relevant CGT asset (i.e. either the underlying asset disposed of or the right to receive compensation).
89. Although, as discussed, there are some situations in which CGT will not be levied on damages, this is not always the case. *Coshott and Commissioner of Taxation* [2014] AATA 622 provides a good illustration of this issue.<sup>37</sup> One of the issues in that case was whether a capital gain arose from a receipt by a taxpayer of money which is in settlement of a claim by the taxpayer seeking damages for negligence and breach of contract.
90. The Tribunal found that the causes of action pleaded by the taxpayer in her statement of claim were CGT assets. When the deed of settlement was executed, the deed operated to release the causes of action pleaded against the defendant. CGT event C2<sup>38</sup> happened because the CGT assets (being the causes of action) ended by release, discharge or satisfaction or by being surrendered. A capital gain was made at the time when the taxpayer entered into the settlement deed.
91. Given the potential CGT impact on damages, it is prudent for parties to consider whether to gross-up any damages for possible CGT.

#### **4. Superannuation death benefits**

92. With the rise of self-managed superannuation funds (SMSFs), there can be disputes about where death benefits get paid on death of a member. Often it is the remaining trustees of the fund who have discretion to determine to whom those death benefits are paid (in the absence of a binding death benefit nomination).

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<sup>35</sup> See *ATO ID 2010/213* and *Whitaker v FCT* (1998) 82 FCR 261.

<sup>36</sup> s 51-57, ITAA97.

<sup>37</sup> An appeal from the case was allowed in *Coshott v Commissioner of Taxation* [2015] FCAFC 71, but not on this particular point.

<sup>38</sup> See s 104-25, ITAA97.

93. In settling such disputes, advisers need to be mindful of the different tax consequences that can arise depending on where the death benefit is paid.
94. For example, the taxable component of a lump sum death benefit will, if paid to a death benefits dependant, be tax-free but will be taxable if paid to another type of beneficiary.<sup>39</sup>
95. A “death benefits dependant” is a deceased person’s:<sup>40</sup>
- (1) Spouse or former spouse;
  - (2) Child aged less than 18 years;
  - (3) Any other person with whom the deceased had an interdependency relationship just before they died (this is also a defined concept); or
  - (4) Any other person who was a dependant of the deceased just before they died.
96. A full consideration of the tax treatment of death benefits is beyond the scope of this paper but practitioners should be mindful of potential tax consequences when settling disputes involving SMSFs and death benefits.

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<sup>39</sup> See Division 302, ITAA97.

<sup>40</sup> s 302-195, ITAA97.