Compensation Payments

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Are compensation payments subject to capital gains tax?

There has been considerable focus recently on the tax treatment of compensation payments or damages, particularly for non-personal injury cases. Whether the payment will be taxable for the recipient thereby reducing the value in the hand of any payment received is a difficult area. In taxation ruling **TR 95/35: Capital Gains: Treatment of Compensation Receipts,** the Taxation Commissioner sets out his approach.

Although the ruling attempts to clarify the issue, it remains an area requiring detailed analysis on a case by case basis. Any litigation or claim involving a potential compensation or settlement payment must take the tax issues into account to achieve the most tax efficient outcome.

Taxation Office approach

The Ruling discusses when such payments will be treated as ordinary assessable income. For instance, compensation for lost profits only will generally be treated as fully assessable. The contentious area, however, concerns the application of the capital gains tax (CGT) provisions to payments if they are not otherwise taxable.

Broadly, the CGT provisions will apply in one of two ways:

- **If the compensation is received for the loss of an underlying asset** (or part of such an asset), the compensation will be treated as consideration for the disposal of that asset. Compensation for damage to property is an example. Any resultant gain or loss will depend on the indexed cost base of that underlying asset.

  If the compensation is received for the permanent reduction in value of a post-CGT asset (but the asset continues to exist) the compensation received will be treated as a recoupment of the asset's cost. That is, the Commissioner says the CGT cost base of the asset will be reduced by the compensation amount. Any excess, however, will be taxable as a capital gain.

- **If the compensation is not received in respect of an underlying asset, then:**
  - the compensation will relate to the disposal of an intangible asset being the right to seek compensation. Effectively the Commissioner considers the right to sue is an asset for CGT purposes;
  - any capital gain arising on the disposal of that right is based on its cost base which will generally be restricted to legal fees. Any actual economic loss suffered by the claimant will not be treated as being part of the cost base;
  - the asset will be treated as being acquired when the wrong or injury occurred and will include all rights arising during the process of pursuing the claim; and
  - the CGT liability is triggered when the right is disposed of that is, when the claim is satisfied, surrendered, released or discharged.

If applicable, this could have the result that the full amount of damages paid to compensate a claimant for a real loss suffered could be taxed as a capital gain. That means that unless that amount is increased to reflect that tax liability, the claimant will not be properly compensated for the actual loss suffered.

Undissected lump sum payment

Often an overall figure, encompassing all claims, is agreed between parties to settle the matter. If the various components of the lump sum cannot be determined (even if some claims may be tax exempt such as with personal injury), the entire lump sum will be treated as being received for the disposal of the right to seek compensation, that is, the entire amount will be subject to CGT. Therefore, in certain cases it may now be preferable to dissect the lump sum payment.

Interest

Interest awarded as part of a compensation amount is assessable income of the taxpayer.

Taxation adjustments

Any adjustment or "gross up" to reflect the potential liability of a receipt will also be treated as compensation in respect of the asset disposal. Hence the "gross up" must also be tax adjusted. The most convenient way to do so is to divide the primary settlement amount by (1 - the applicable tax rate).

Ensure compensation is adequate

Therefore, it is imperative that damages or compensation payments are analysed *before settlement* to assess any potential tax liability. If appropriate, the amount of damages claimed should be "grossed up" or increased to reflect the potential tax liability. If this is not done, the claimant risks not being adequately compensated for the actual economic loss suffered.

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