Taxation on settlements

by Michael W Inglis*

There are now many cases where the damages, or settlement monies, received in connection with a court action are assessable (in large part) by virtue of the CGT provisions of the Income Tax Assessment Act 1936 (Cth).

This fact is unfortunately not widely appreciated, and many clients still labour under the misapprehension that such damages or settlement monies are generally received free of tax.

There is evidence to suggest that a number of taxpayers have failed to disclose the reciept of damages or settlement monies in their tax returns -- in cases where they should have -- through sheer ignorance.

There is also evidence to suggest that a number of clients may well have accepted *inadequate* settlement offers because they have assumed (wrongly, as it turns out) that the settlement proceeds would be free of tax in their hands.

Practitioners thus need to be most alert to the possibility of CGT applying in the litigation context.

For the assistance of readers, the following represents a check list of the more material considerations.

In many cases, rights to sue will represent 'choses in action' and thus 'assets' for CGT purposes, s160A(a).

The obtaining of damages *or* the settlement of the relevant action will usually represent the *disposal* of the relevant asset (being the 'chose in action'), s160M(3)(b) when read with s160M(1).

The damages *or* settlement proceeds will usually represent the *consideration in respect of the disposal* of the relevant asset, s160ZD(1)(a), and compare s160Z(1)(a).

Putting matters such as legal expenses to one side, there will often be difficulty in establishing any significant cost base of the relevant asset to the taxpayer, s160ZH(1)(a)-(e).

In the light of the foregoing, the stage is often set for Part IIIA to apply in respect of the disposal of the 'chose in action' -- which is worked by the receipt of damages or the settlement of the action -- with the very real prospect of a substantial capital gain accruing to the taxpayer (particularly because of the insufficiency of cost base).

However, it is important to recall that, as a general proposition, Part IIIA only applies in respect of disposals of assets *acquired on or after 20 September 1985*, s160L(1) and (2).

Thus a critical question, in the present context is: *When was the relevant chose in action acquired by the taxpayer?*.

Part IIIA contains general rules for determining the date of acquisition of an asset, see generally s160U(1)-(7). It is far from easy to accommodate *any* of these general 'timing' rules to the acquisition of an asset (being a chose in action) in the present litigation context.

However, in very many cases, the above critical question demands and answer if the CGT consequences of proceeding to judgment *or* settling the matter are to be revealed.

Two particular cases where Part IIIA willnot have such a draconian application are the following:

First, s160ZB(1) provides:

"A capital gain shall not be taken to have accrued to a taxpayer by reason of the taxpayer having obtained a sum by way of compensation or damages for any wrong or injury suffered by the taxpayer to his or her person or in his or her profession or vocation and no such wrong or injury, or proceeding instituted or other act done or transaction entered into by the taxpayer in respect of such a wrong or injury, shall be taken to have resulted in the taxpayer having incurred a capital loss."

In Hepples v FCT (1990) 21 ATR 42, Gummow J expressed the view that s160ZB(1) was "included for more abundant caution" because a "cause of action for personal injury...would be personal in nature" and thus, in His Honour's view, not an 'asset' for CGT purposes (see at 21 ATR 66).

Be that as it may, there are undoubtedly, even on Gummow J's view, a great many 'rights to sue' which answer the description of a 'chose in action' and an 'asset' for CGT purposes, and in respect of which the s160ZB(1) exemption could have no possible application.

In such cases the issues raised in this column are of immediate relevance and importance.

Second, there can be no doubt that one of the most important (and interesting) *characterisation* questions in the CGT context is whether the practitioner is dealing with only *one* asset (for CGT purposes) or *more than one* asset.

This question is often a vital one in relation to part disposal issues (s160R) and s160M (6) or (7) issues.

In the present context, the following extract from the Minuites of the Meeting of the CGT Subcommittee of the Taxation Liaison Group of 2 March 1989 is most material:

"The Institute of Chartered Accountants asked, when compensation or damages are received after 19 September 1985 in respect of an asset which was acquired before 20 September 1985, whether the compensation or damages are received in respect of the disposal of the 'underlying asset' or in respect of a separate asset, being the right to bring an action in negligence or contract. The ATOs view is that if the underlying asset os a real (or corpreal) asset, such as land or goods, the compensation relates to the disposal of the asset."

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