



Tax On Court Settlement / Compensation

Author Alan Maddick 24/11/2021 Adapted from a paper submitted as part of my Master of Tax at Melbourne University.

When you receive payment in compensation this will generally be taxable, for example you may receive a lump sum in compensation for a loss you have suffered like an injury or a financial loss like loss of income from unfair dismissal or damage to your business.

The default position is that this payment will be taxable (ie you will need to pay tax on the payment)

When you receive compensation, it retains the nature of what it was originally and will either be classified as *Ordinary Income* or *Capital*. For example a payment for unfair dismissal is essentially a payment for loss of wages, wages are Ordinary Income and so the payment is also Ordinary Income. To avoid doubt the legislation contains a specific section at s 15-30 that specifically includes payments from compensation:

“Your assessable income includes an amount you receive by way of insurance or indemnity for the loss of an amount (the lost amount) if:

(a) the lost amount would have been included in your assessable income and

*(b) the amount you receive is not assessable as * ordinary income under section 6-5.”¹*

This classification between Ordinary and Capital Income can be important as capital sums are often taxed concessionaly for example they may be eligible for a 50% discount² or tax exempt under the exemption for personal injuries in s 118-37.³

¹ *Income Tax Assessment Act 1997 Cth S 15-30*

² *Income Tax Assessment Act 1997 Cth s 115-25*

³ *Income Tax Assessment Act 1997 Cth s 118-37*



A recent case *Kort v FCT 2019*⁴ is a good example of the way different components can be treated as Capital or Ordinary Income.

In *Kort* the taxpayer received a lump sum payment in settlement of legal proceedings he had commenced against Zurich Australia Limited (ZAL) and Zurich Australian Superannuation Pty Limited (ZAS) relating to a workplace injury he had suffered. The taxpayer had filed a statement of claim for;

(a) income replacement benefits under an income protection (IP) policy, the total possible claim would be 30 years at a monthly payment of \$5667.97 - Gross \$2,040,469; and

(b) total and permanent disability (TPD) payments, under a term life insurance policy 738,729; and

(c) mental anguish, personal insecurity and distress as a result of the insurer's failure to make monthly payments of income in breach of the IP policy. (no amount listed in published court report)

The taxpayer agreed to an out-of-court settlement of \$1.1 million in respect of the legal proceedings. Under a release agreement, the taxpayer received \$297,000 for his TPD claim and \$803,000 as the balance of the settlement sum. A clause in the release agreement was broadly worded to release ZAL and ZAS from all forms of claims the taxpayer had.

The TPD Claim amount was not disputed by the Tax Office, a TPD payment is Capital in nature and as it is a compensation payment in respect to illness or injury any gain made can be disregarded under s118-37. A payment from a super fund when permanently disabled would also normally satisfy a condition of release and be tax free.⁵

The taxpayer applied to the Commissioner for a private ruling on whether the amounts received by him were assessable. The Commissioner ruled balance of the lump sum payment (\$803,000) was fully assessable as it was paid with respect to the replacement of income. When the Commissioner disallowed his objection to the ruling the taxpayer applied to the AAT for a review of the objection decision in relation to the payment of \$803,000.

⁴ *Kort v FCT 2019 ATC 10-491*

⁵ *Superannuation Industry (Supervision) Regulations 1994 Reg 6.01*



The taxpayer submitted that the payment of \$803,000 was a single undissected lump sum, composed of income and capital amounts, paid in settlement of all his claims against ZAS and ZAL. Accordingly, the whole payment was capital in nature, which could not be part of his assessable income. The taxpayer also submitted that the payment was exempt from capital gains tax (CGT) under s 118-37(1)(a) of the Income Tax Assessment Act 1997 because the sum was a capital gain relating directly to compensation or damages for a wrong, injury or illness suffered by him.

The Commissioner submitted that the entirety of the \$803,000 was paid as compensation for the loss of income replacement benefits under the IP policy, taking into account the rights under the policy, the claims, the settlement of those claims and the rights that the taxpayer surrendered. The Commissioner also submitted that;

(a) the relative percentages of the amounts paid under the settlement corresponded to the taxpayer's two claim amounts for the TPD and IP policies, which indicated the \$803,000 was paid to settle the income protection claim alone; and

(b) the substance and commercial reality of the settlement was that the amounts that did not relate to claims under the TPD policy must relate to the claims under the IP policy.

The Court found that;

1. The lump sum payment of \$803,000 was not assessable income of the taxpayer. It was a single undissected sum settling all remaining non-TPD claims with the effect that the whole of the payment was capital in nature. The payment was not apportioned exclusively to compensate the taxpayer for the loss of income benefits, but rather was paid to compensate the taxpayer for all claims, other than the TPD claim, including a claim for loss and damage caused by the insurer's conduct.

2. Part of the \$803,000 payment to the taxpayer might amount to a capital gain relating directly to compensation or damages for a wrong or injury that the taxpayer suffered personally. However, it was not possible to dissect which portion of the payment was attributable to that part of the claim made in the statement of claim. Further, there was no evidence before the AAT of a wrong or injury suffered personally by the taxpayer. Therefore, s 118-37(1)(a) did not apply to the lump sum amount of \$803,000 to make it exempt from CGT.



In *Sommer v FCT*⁶ a settlement relating to an Income Protection policy was held to be Assessable Income,⁷ in *Sommer* the entire payout was able to be directly connected to the taxpayers Income Protection Policy as his Honour was not satisfied that the settlement related to sums where apportionment was an issue.⁸ (despite the original claim including various possible sums)

This principle has also been applied in cases involving wrongful dismissal claims; while the claim is both for lost income and other components (hurt stress etc) the entire settled sum was held to be income of the claimant and not capital in nature in multiple cases, for example *Le Grand v FCT*,⁹ *FCT v Pitcher*¹⁰

The commissioners sets out the tax office's view in TR 95/35¹¹

If you have received a court or litigation settlement and would like advice on your tax position please get in contact. We can also advise you on the possible tax effect of any court payout or settlement during your court case; allowing you to negotiation understanding your tax position.

Please note this is just a general discussion of the relevant principles. Please get advice before acting.

Author: Alan Maddick

alan@accountantmm.com.au

0411 551 838

⁶ *Sommer v FCT* 2002 ATC 4815

⁷ *Sommer v FCT* 2002 ATC 4815

⁸ *Ibid* [19][20]

⁹ *Le Grand v FCT (2002)* 124 FCR 53

¹⁰ *FCT v Pitcher* 2005 ATC 4813

¹¹ *TR 95/35 CGT: treatment of compensation receipts*, ATO [18]