Settlement Release Deed

What are the taxation implications for Client A and Client B regarding the Settlement Amount?

Facts

Client A and Client B have received a Settlement Release Deed from ABC Partners Legal Pty Ltd with an offer of payment of $100,000. Security for the purchase of Property 2 in the name of Client A & B was obtained over Property 1 held by Client A. In negotiating the purchase of the property it was explicitly requested that the property held by Client A not be used as security. On securing a sale of Property 2 at a later date it became evident that it had been held as security for Property 2 and for a number of other reasons the sale was terminated.

Reasonably Arguable Position

Client A

Compensation received by Client A relates to Client A's SA property and is a reduction in the cost base of the property and is not immediately assessable. The amount will be taken into account when Client A sells the property essentially reducing Client A's cost for the property by the amount of the compensation

Client B

Compensation received by Client B does not relate to an asset owned by Client B as the Queensland property was not affected by the advice from the financiers. Accordingly based on the current agreement Client B's share of the compensation would be fully assessable as a capital receipt. This capital receipt would not be subject to a 50% discount

Compensation

A receipt of compensation can be in the nature of income or capital. The nature of this receipt relates to a lump sum payment relating to incorrect security for a property transaction and is not in the nature of income and therefore is not assessable under ordinary income principals. The amount is a lump sum capital receipt and therefore the Capital Gains Tax provisions need to be addressed.

Capital Gains Tax

Capital gains tax applies generally to the disposal of an asset. An asset includes a right to sue for damages. However where compensation relates to an underlying asset, the compensation can be taken into account in the calculation of the capital gain in regard to that property, or reduce the cost base if the asset is not being sold. If an underlying asset is evident this takes precedent over the right to sue capital gain. The difference between the two types of capital gain is that the right to sue does not attract the 50% discount for other asset disposals as it cannot be held for 12 months.

Client A Compensation

The underlying asset approach requires that the asset is permanently damaged by the event creating the right to compensation. Where the underlying asset approach applies and the underlying asset has not been disposed of the receipt of compensation is a reduction in the cost base of the underlying asset and is taken into account when the underlying property is sold. Accordingly on receipt of the compensation by Client A we believe it is reasonable to argue that no amount is required to be included in her assessable income in the year of receipt.

Client B Compensation

The facts as they apply to Client B are therefore required to be considered separately as Client B does not have an ownership interest in the Property 1. We cannot identify an underlying asset in regard to the compensation received by Client B. We cannot identify any damage to the Property 2 due to the loan for Property 2 being secured over Property 1.

Accordingly the amount of compensation received by Client B is fully assessable as a capital gain for the disposal of their right to sue the financiers. As this asset is created on its disposal, the 12 month holding period for the 50% discount is not satisfied and the full amount of Client B portion of the compensation is assessable income.

ATO Rulings for reference

TR 95/35

TR 95/35 (taxation ruling issued by the ATO: Income tax: Capital Gains: Treatment of Compensation Receipts, example 5 para 271-272)

TR 95/35 (taxation ruling issued by the ATO: Income tax: Capital Gains: Treatment of Compensation Receipts, example 7 para 280)