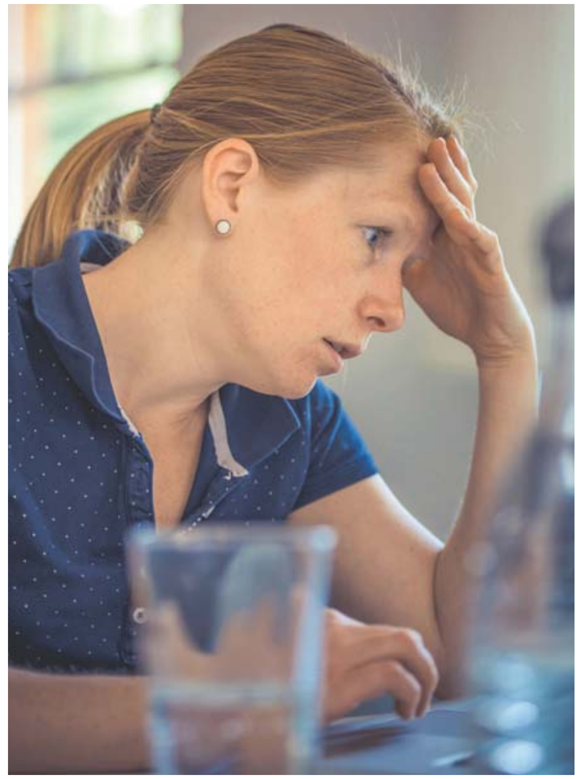
The tax treatment of compensation payments can be tricky



If you have had a rental or commercial property damaged by recent summer storms (or bushfires or floods) you may have received an insurance payout to cover the damage. You may be surprised to know that this payout is subject to capital gains tax (CGT) on the basis that it arises from your right to seek compensation (being a CGT asset itself). However, the tax law and the ATO will treat it concessionally depending on what exactly the payout is for and how it will be used.

For example, if the payout is for the "destruction or loss" of the whole or part of the property, the payout won't be subject to CGT at that time – but only if it is used to acquire a replacement asset within the required time (generally two years). This is because a "concessional roll-over" applies in the circumstances. However, there may be an immediate CGT liability (and/or other CGT consequences) if only some (or more) than the amount of the payout is used in acquiring a replacement asset.

On the other hand, if a payout is received for merely some "permanent damage" to the property then a different CGT concession will apply – namely, there will be a reduction in the cost base of the property for CGT purposes by the extent of the compensation received (and whether or not the proceeds are used to repair or restore the damaged property).

So, if you find yourself in this situation, it is vital to see your tax professional to help assess what situation you fall into – and furthermore how the compensation is exactly treated in that case.

In the different case where you receive compensation for wrongful dismissal from work and/or for injury suffered at work, it is also vital to seek professional advice. This is because such compensation can potentially be treated in one of several ways:

- Firstly, it may be treated as assessable income to the extent it is a substitution for lost income – regardless of whether it is received in a lump sum form or not and however it is calculated.
- Secondly, it can be treated as being exempt from being assessable income (and CGT) where it is received for injury, the loss of physical capacity, illness, pain, suffering or where it is paid under anti-discrimination legislation.

However, determining which category of compensation such a payment falls into is not always easy – especially where it may be an out-of-court settlement payment which comprises both types of payments. While generally such payments will not be taxable, if they are an out-of-court settlement and the whole or part of the payment can be identified as comprising compensation for lost income (by whatever means, such as the initial pleadings), then that component can be assessable.

So, suffice to say your professional adviser is invaluable in this situation – and in particular before agreeing on the receipt of any such settlement payment. ■