The potential GST consequences of out of court settlements

The majority of all commercial disputes are settled without a trial. Senior Associate Sarah Armstrong examines the impact of the recent final ruling by the Australian Tax Office on the GST consequences of out of court settlements.

Overview

• The act of settling is not a taxable supply for GST purposes but GST may be payable if a payment is made in respect of an earlier taxable supply or if the settlement creates a new taxable supply.
• There will be no GST liability on any settlement monies that relate to legal fees.

Does the act of settling give rise to a GST liability?

In the majority of cases, the act of settling a dispute will not, of itself, be a taxable supply. Only where there is overwhelming evidence that the plaintiff’s claim was ‘entirely lacking in substance’ will the act of settling a dispute amount to a taxable supply. Rarely will a claim be so weak as to be entirely lacking in substance. The fact that the defendant denies liability does not mean that the plaintiff’s claim is entirely lacking in substance.

Damages

If damages are paid in respect of something that was not itself a taxable supply and the settlement does not give rise to a taxable supply, the settlement will not be subject to GST. Examples include damages for property damage or personal injury or for negligence causing loss of profits.
When will there have been an earlier taxable supply?

Where the dispute relates to an earlier taxable supply, any settlement payment will be treated as having been made in consideration for the earlier supply and will attract GST. This will typically arise in the situation where the dispute is about non-payment for work done or goods purchased.

In these circumstances, the parties should make clear in the settlement agreement whether the settlement sum is inclusive or exclusive of GST and, if it is exclusive of GST, which party is to bear the burden of any GST liability.

When will the settlement create a taxable supply?

Where the rights and obligations created by the settlement give rise to a new taxable supply (or ‘current supply’), any settlement payment will be treated as having been made in consideration for the current supply and will attract GST.

The GST legislation adopts a very broad definition of the concept of ‘supply’. A supply includes the creation, grant, transfer or assignment of any right. The creation of a right as part of the settlement will typically arise in the context of intellectual property disputes — for example, in the creation of the right for one party to use the other party’s trade name in the future.

Again, the parties should make clear in the settlement agreement whether the settlement sum is inclusive or exclusive of GST and, if it is exclusive of GST, which party is to bear the burden of any GST liability.

Legal fees

No GST is payable on the portion of the settlement monies that relates to legal fees. However, in most cases, GST will have been charged on the costs when they were originally billed to the party in question.

If that party is not registered for GST, it will be unable to claim an input tax credit for the amount of GST charged by its lawyers and the actual cost to it will be the GST-inclusive amount. On the other hand, if the party is registered for GST, and therefore is able to claim an input tax credit for the GST charged by its lawyers, the actual cost to it will be the GST-exclusive amount.

Both parties should take this factor into account when negotiating the amount that will be paid in respect of costs.

Apportionment

If settlement monies only relate in part to a taxable supply, it is important to ensure that the settlement agreement expressly states how the payment is to be apportioned. Otherwise, parties potentially expose themselves to further litigation when they cannot subsequently agree on how the settlement breaks down. Provided that any apportionment is made on a reasonable basis, the ATO will accept it as correct and conclusive as to the amount in respect of which GST is payable.

Conclusion

The introduction of the GST has brought an added complication to settlement discussions, making it imperative to involve a GST expert at an early stage.

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