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Consumers compensated by financial institutions still need to consider tax

With the ongoing financial services Royal Commission, and likely future cases brought before various courts for compensation — or indeed the present building of class action lawsuits on the back of various revelations to come out of the Royal Commission — the ATO has felt the need to run over the rules (as they stand) regarding the taxation of compensation paid to individuals for advice from financial institutions.

The ATO says that taxpayers will need to consider certain tax consequences if they have personally received compensation from a financial institution because they:

- received advice from the institution that was found to be inappropriate, or
- paid for advice that they did not receive.

The ATO says the tax treatment of the compensation depends on what the compensation is being paid for, and how an investor holds (or held) the investments.

A compensation payment can include some or all of:

- compensation for loss on an investment
- a refund or reimbursement of fees
- interest.

The compensation may relate to multiple investments, with different amounts of compensation granted against each one. The ATO says an individual will generally be required to consider the tax consequences of each compensation amount separately.

Compensation for loss of an investment

You may receive compensation for a loss amount if the value of your investments is lower than it would have been if you had received appropriate advice. There are different tax treatments depending on whether the compensation relates to investments you have disposed of or existing investments.

Compensation for investments you have disposed of

When an investor disposes of an investment, a capital gain or loss may be realised, which is generally reported in the financial year the asset was disposed.

The compensation can be treated as additional capital proceeds relating to the disposal of those investments. If you have more than one investment, you will be required by the ATO to apportion the additional capital proceeds to each disposal.

Continued overleaf

Most investors will be Australian residents for tax purposes, so if the compensation relates to investments held for at least 12 months you will be entitled to the 50% CGT discount. You may therefore need to request an amendment to your tax return to reflect the additional capital proceeds if the compensation relates to disposing of investments in a previous financial year.

Compensation in relation to existing investments

If you have been compensated for investments you still own, you need to reduce either the cost base or the reduced cost base by the compensation amount received, depending on whether you make a loss or gain when you dispose of the investments. Also it may be necessary to apportion the compensation amount where it relates to more than one investment.

Refund or reimbursement of adviser fees

A compensation payment may include an amount that is a refund or reimbursement of adviser fees. The tax treatment of this amount depends on whether you claimed a deduction for the adviser fees in your tax return.

Deduction claimed for adviser fees

If a deduction was claimed for the adviser fees in a tax return, the amount received as a refund or reimbursement will form part of your assessable income in the year it was received.

Deduction not claimed for adviser fees

If there was no deduction claimed for the adviser fees, the refund or reimbursement does not form part of assessable income. However, where the adviser fees were included in the cost base or reduced cost base of any investments made, you must reduce the cost base and reduced cost base by the amount of the refund or reimbursement.

The cost base and reduced cost base are used to calculate capital gains or losses when an investor disposes of an investment. ATO advice is to report the resulting capital gain or loss in the tax return for the year in which you dispose of the investment.

If you dispose of these investments and have returned any resulting capital gain or loss in a previous income year, you may need to amend your tax return for that year.

Interest component

The interest component is assessable as ordinary income, and should be included in your tax return in the financial year it was received.

Example from the ATO: Investments held individually

Noel paid $2,000 to a financial institution for investment advice in May 2010. Following that advice Noel invested $100,000 in a high risk-high growth investment fund. The investment fund performed poorly and Noel disposed of the investment for $70,000 in January 2015.

Noel had claimed a deduction for the advice in his 2009-10 tax return. CGT event A1 happened when Noel disposed of all the investments in his portfolio. Noel included a capital loss of $30,000 in calculating his net capital gain in his 2014-15 tax return.

The financial institution reviewed the advice given to Noel and determined that the advice was inappropriate for his circumstances as he should have been advised to invest in a more conservative portfolio.

In 2018 the financial institution offered Noel compensation of $40,000 in respect of the advice. The payment included compensation of $30,000, a refund of the adviser fees of $2,000 and an interest component of $8,000. Noel accepted the offer of compensation in June 2018.

Noel treats the $30,000 compensation for loss amount as additional capital proceeds received for the investments. Noel recalculates his capital loss for 2014-15, reducing it to nil. Noel will need to amend his 2014-15 return with the new calculation.

As Noel had claimed a tax deduction for the adviser fees in his 2009-10 tax return, the $2,000 refund of those fees is included in his assessable income in his 2017-18 tax return. He will also include the $8,000 interest component in his 2017-18 tax return.