Are you advising your clients *about the availability of* structured settlements?

Structured settlements have been talked about in Australia for years. Finally the breakthrough has been made and the long sought-after change to the tax law has been announced.

The Announcement

On 26 September 2001, the Assistant Treasurer, Rod Kemp, announced that from that date, structured settlements would be tax free in Australia (subject to the passing of amendments to existing taxation law). This announcement was the culmination of years of lobbying work, combined with some short-term political imperatives.

The Federal Opposition had just weeks earlier announced that it would make structured settlements tax free, in the context of its medical indemnity policy. An election was just around the corner, so the time was right for the political will to overcome the reluctance of the Department of Treasury to make structured settlements tax free.

Lobbying Background

Structured settlements were introduced as a result of similar tax changes made in the United States and Canada in the late 1970s and the United Kingdom in the 1980s.

The New South Wales Motor Accidents Authority (MAA), which oversees the Compulsory Third Party (CTP) scheme in NSW, took an active interest in structured settlements in the mid 1990s. In 1997 and 1998 the MAA engaged me to write a submission to the Federal Government putting the case for an amendment to the tax law making structured settlements tax-free.

This first submission to the Federal Government was rejected on the basis that accident victims should choose periodic payments of compensation because they are inherently sensible, regardless of the tax consequences!

We realised that it was important to expand our lobbying efforts and demonstrate to the Federal Government that structured settlements not only had the support of the NSW MAA, but also had the unanimous support of all stakeholders and this was an issue affecting all common law personal injury claims Australia-wide.

To this end the Structured Settlement Group (SSG) was formed in 1999. APLA was a founding member. Other members include the Law Council of Australia, the Insurance Council of Australia, the Institute of Actuaries of Australia, Injuries Australia, the Australian Medical Association, United Medical Protection, and others.

The SSG, working with the assistance of activist Judie Stephens, Federal Liberal Danna Vale MP, actuary Richard Cumpston and tax consultant Terry Dwyer, launched a new proposal to Government. Like the

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Jane Ferguson at the
APLA National Conference 2001.

original MAA proposal, the SSG proposal recommended a tax change based on the UK legislative model for structured settlements.

What are structured settlements?

In essence structured settlements are a way of paying compensation for personal injury. They are available as an option, by choice. Instead of opting for a single lump sum settlement, an accident victim can opt for a smaller up-front lump sum, plus periodic payments for life, funded by an annuity or annuities.

The up-front lump sum is used to pay for bills and debts, to pay lawyers' fees, repay social security, modify a house, purchase special equipment, etc. It usually accounts for one third or one half of the total settlement funds. The periodic payments are used to cover ongoing expenses such as medical and care costs, rent, and living expenses. They are designed so that the annuity payments match, as best as possible, the accident victim's changing financial needs over time.

Why do they exist?

The primary objective of structured settlements is to give accident victims a tax effective way of ensuring their financial security.

Governments recognise that it is in their interests to encourage periodic payments, as this is likely to mean fewer accident victims end up having to fall back on social security.

Defendant insurers are happy to use structured settlements, because from their point of view they are just like lump sum settlements. The defendant insurer can settle the case, pay out the claim, and close the file. They do not make the periodic payments; they simply buy an annuity or annuities (that have been agreed and approved by the plaintiff) from a life insurance company.

Tax issues

Until 26 September 2001 tax was the main stumbling block, discouraging the use of structured settlements. A lump sum settlement is usually characterised as capital and received by an accident victim tax-free. However, when that person invests their lump sum they pay tax on any interest or investment earnings.

The Australian Taxation Office previously maintained that if an annuity was purchased by or for an accident victim as part of their compensation, then the purchase price of the annuity would be tax-free, but the interest/investment component of every payment would be taxable.

Now plaintiffs have a choice between taking a lump sum (and paying tax on the investment earnings), or taking part of their settlement as entirely tax-free periodic annuity payments.

Features of the Government's Model

In order to achieve tax-free status under the Government's announced model, the structured settlement must meet the following criteria:

- The person receiving the annuity must have suffered the personal injury. This means that unlike overseas structured settlements, Australian structured settlements cannot be elected in death cases. A surviving spouse, for example, cannot receive their compensation in the form of tax-free periodic payments.
- The compensation must not arise in relation to an action against the person's employer. The SSG fought to have common law workers compensation payments included, but the Government was adamant that they should be excluded. The Government stated that the policy reason for its support of structured settlements was to help provide ▶

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periodic payments where previously only a lump sum was available. Statutory workers compensation payments are already paid periodically. There may be room for the Government to move on this position in time (see below).

- The money that is used to purchase the structured settlement must be money that would otherwise have been characterised as capital and tax-free. The aim is to retain the tax-free status of a capital sum, not to avoid paying tax on a taxable sum.
- The annuity must be provided by an authorised life annuity provider. This ensures that the annuity is provided by a financial institution that meets the appropriate Australian prudential regulations (overseen by APRA).
- The annuity must provide, at a minimum, for periodic payments at least equivalent to the current Aged Pension, indexed to the CPI. This provides a floor on the smallest types of structured settlements that can be arranged.
- The annuity payments need to be at least monthly (eg. not annual payments). The objective is to ensure that the accident victim receives regular payments to meet their needs and expenses.
- The annuity must not be market linked. The aim here is to ensure that the accident victim has full security and is not taking on any market risk.
- The annuity must be non-commutable (it can't be cashed in for a lump sum) and non-assignable (it can't be sold to a third party for a lump sum).
- The annuity may have a minimum guarantee period of up to 10 years. This provides an accident victim with some comfort – to know that if they enter into a structured settlement then die shortly thereafter, the periodic payments will continue to be paid to their named beneficiaries or estate for 10 years.

Opportunities to improve the model?

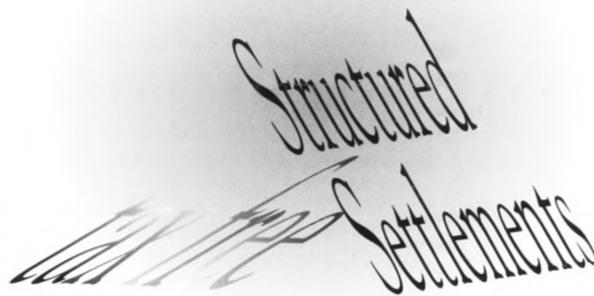
The Government had wanted to impose a 10-year sunset clause to the legislation, so that the tax exemption would only apply to structured settlements entered into in the next 10 years.

The SSG, and particularly APLA, pushed to replace the sunset clause with a review clause that will ensure that the legislation is reviewed within at least 5 years of commencement. The review will provide an opportunity to revisit issues such as the inclusion of common law workers compensation.

What this means for plaintiff lawyers

TThe SSG's objective was achieved on 26 September 2001 when the Government announced it would introduce legislative amendments confirming the tax-free status of structured settlements. The legislation, when passed, will be backdated to 26 September2001. The policy has bipartisan support, so should pass quickly in early to mid 2002.

The plaintiff lawyer should be aware that some of your current clients may be able to negotiate a structured settlement, and that this option should be considered, although any final settlement will need to wait until the legislation is passed.



What types of cases are affected?

Structured settlements will be able to be used in common law cases, such as motor vehicle accidents in NSW, medical negligence and public liability cases. They won't be available in workers compensation cases, and will be most relevant for large claims.

How does the settlement process change?

Plaintiff lawyers will still need to go through the usual processes in terms of assessing quantum – considering the various heads of damages available, etc.

It usually makes sense to look at a structured settlement from both the top down and the bottom up. Top down involves looking at the conventional lump sum and determining the value in that sum being converted into a structured settlement that would be worth more because of its tax-free status. Bottom up involves looking at your client's needs over time and matching those financial needs to an annuity. You look at how much an annuity would cost that would meet those needs over time.

Either side may raise the idea of a structured settlement. Structured settlement offers will go back and forth until both parties are able to agree. At that point a settlement agreement can be entered into.

The defendant or its insurer will then pay the up-front lump sum amount directly to the plaintiff, and they will then buy the annuity or annuities for the plaintiff from a life insurance company. Thereafter the plaintiff has a direct contractual relationship with the annuity provider.

Note that in order for the *annuity payments* to be tax-free, the defendant or its insurer must purchase the annuity for the plaintiff. The annuity will not be tax-free if the plaintiff receives a lump sum settlement and then uses that money to buy themselves an annuity. This new tax rule helps to secure tax-free periodic payment settlements, it does not secure tax-free investments using lump sum settlement funds.

Pros and cons

When advising your client you will want to point out the pros and cons of structured settlements compared with conventional lump sum settlements.

Some of the advantages include:

- The security and peace of mind of regular guaranteed payment for life. The periodic payments are fixed by

the annuity contract and the life insurer takes on the investment risk.

- The tax savings (i.e. paying no tax on investment earnings over time) are very significant in relation to a large settlement sum.
- Spendthrift protection. The plaintiff may need to be saved from themselves (in terms of poor budgeting and investment skills, possibly gambling or other addictions) or their friends or relatives (who may not have the plaintiff's best long term financial interests at heart).
- The fact that the money will not run out for as long as they live. The life insurance company takes on the mortality risk.

Some of the disadvantages are:

- No access to the full lump sum. There is an opportunity cost associated with opting for an annuity settlement rather than being able to invest in possibly higher yielding investments such as shares.
- Once the settlement agreement has been finalised, the settlement is fixed and cannot later be changed. Plaintiffs need to carefully plan a structured settlement and can use part of the up-front lump sum to invest conventionally for unexpected contingencies.
- There is also the risk of life insurance company failure. No Australian life insurer has failed, but this risk must be considered as a possibility. Of course it must be weighed up with the risks associated with all other types of investments. Banks have failed and share markets can be volatile. No investment is risk free and on balance life insurance annuities are very safe.

So what should I advise my clients?

Plaintiff lawyers should advise their clients (in appropriate cases) of the possibility of this new settlement option. Failure to so advise may put you at risk of a future negligence claim from a client who opts for a lump sum, blows that lump sum, and later argues that they would have chosen a structured settlement if they had been properly advised.

You should outline the availability and features of structured settlements, as well as the pros and cons compared with lump sums. The new financial services regime introduced by the *Financial Services Reform Act* 2001 means that lawyers have to be particularly diligent in not crossing the line between legal advice and financial advice.

A prudent plaintiff lawyer will ensure that their client receives the benefit of specialist financial advice in order to properly weigh up lump sum and structured settlement alternatives.

What are the defendant insurance companies thinking?

Defendant insurers and their lawyers are still coming up to speed with this new development. They are starting to think about which cases might be suitable to suggest a structured settlement.

They are wondering what impact it will have on settlement costs. Most (sensibly) do not expect that it will reduce the cost of claims. They hope it might be neutral because both parties will always keep an eye to the alternative lump sum.

What are the life insurance companies thinking?

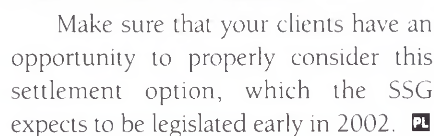
The life insurance companies have not been actively seeking this new market, mainly because they see it as small and difficult. The main problem for life insurers is pricing these types of annuities. Normal annuities are based on normal life expectancies. In fact they are based on the type of people who usually buy annuities – people who tend to live longer than usual!

Life insurers in Australia do not have experience in looking at the life expectancies of seriously injured people (who have less than normal life expectancies). They are therefore looking to multinational parent companies and/or reinsurers for assistance with pricing.

The bottom line

The tax-free status of structured settlement payments make them worthwhile considering, particularly for those seriously injured accident victims who must rely on their compensation money for the rest of their lives. Those with uncertain life expectancy, those who are inexperienced at investing large sums and those who may be vulnerable to requests for financial assistance from friends and family, might all be better off with a structured settlement.

Make sure that your clients have an opportunity to properly consider this settlement option, which the SSG expects to be legislated early in 2002. PL



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