

Using superannuation for personal injury settlements

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This strategy converts a compensation settlement into a tax effective income stream for the recipient's life expectancy, using the normal rules and advantages of the superannuation environment. It is suitable for an individual who receives a lump-sum payment for a serious injury that prevents them from working in the foreseeable future. But the strategy is subject to a number of caveats.

Firstly, one must establish that the investment of the payment is unencumbered by any negative effects on the client's current workers compensation, disability and salary continuance entitlements, and their interplay.

In Victoria, for example, workers compensation payments are offset, dollar for dollar, by any superannuation pension received. Depending on the rules governing them, terminating existing employer and superannuation arrangements can lead to forfeiture of the client's compensation, disability, or salary continuance entitlements. For instance, terminating the employer link can be interpreted in some cases as reducing the recipient's genuine efforts at rehabilitation. Furthermore, some standard income protection policies are correspondingly reduced by any superannuation pension payments drawn at the same time, whereas other more premium-grade policies are not. It is essential, therefore, that the client's financial adviser check that the investment of this particular client's lump-sum personal injury payment is unencumbered by any such issues. Assuming this is so, the strategy could proceed as follows:

The settlement funds the client receives are non-superan-

uation funds and can be used to make an undeducted contribution to super. The client will be eligible to make a contribution as long as they ceased gainful employment due to ill health and, at the date of the contribution, cannot resume that employment because of ill health. The contribution will be preserved. However, the client can immediately apply to the trustees of the superannuation fund to have the benefit released due to permanent incapacity.¹ Once released, the client can draw out the funds either as a lump sum or in the form of an income stream. A suitable income stream may be one that is known as an allocated pension. An allocated pension is flexible and has significant tax benefits which would be further enhanced by the undeducted contribution. Clients, other than those who were self-employed, may also be eligible for the 15% tax offset where the income stream started to be payable due to permanent invalidity.

WHAT OTHER INVESTMENT OPTIONS DOES A PERMANENTLY INJURED CLIENT HAVE?

The client has other options, such as buying a property. This may yield, for example, 5-6%. However, property booms sooner or later come under the pressure/correction of the inevitable market cycle, as some property yields already seem to be. The question is will a 5-6% yield be enough for the client to live on, given that rental income is taxable?

They can also buy a portfolio of direct Australian shares in good quality yield stocks. However, historically, Australian shares have delivered dividends of 4-5%. Although such an income stream would be more tax effective, is this yield enough to live on?

Another option is to place the money in a bank account, such as a rolling term deposit. Here, there are only low-income opportunities, the income is taxable and there are no capital growth opportunities.

On the other hand, by investing in an allocated pension ►

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there are nominated regular income payments, and depending on the asset allocation and investment portfolio mix, there is also growth potential. Further, there is no or very little tax, depending on the income recipient's requirements. Such an income stream can provide for the client's needs, without the hassle of monitoring and keeping track of taxation liabilities, capital gains, inflation, and interest rate fluctuations. Also, allocated pensions created this way may be more flexible for recipients than the structured settlements (complying) annuities recently sanctioned by the Australian Taxation Office. This is especially so in low-interest environments.

Given that the last three years have been very dismal for investors in Australian and overseas equity markets, are allocated pensions still a good investment for voluntary and enforced retirees? In the long-term, investing via an allocated pension is still a tax-effective way to provide clients with exposure to growth assets when they are no longer working. This is because, historically, growth-oriented investment strategies have generally resulted in better long-term outcomes than more defensive investment strategies. As for the unusually poor investment period of the last three years, there are a couple of strategies to mitigate the inevitable and cyclical market declines.

One is to establish a cash fund, or 'pool', within the allocated pension from which the first two or three years' payments would be drawn. If investment markets fall, this would

help investors avoid selling growth assets to draw the required income stream. If investment markets rise, especially early in the pension period, this would allow the growth assets to increase and create a 'wealth buffer.' A reverse dollar cost averaging approach could also be used, where growth assets are sold on a regular basis, say monthly, when it is time to replenish the cash pool.

Another strategy is to segment the portfolio into short-, medium-, and long-term investment pools. Income payments would be drawn from the short-term (cash) pool. In periods of strong market returns topping up the short-term pool may be taken mainly from the long-term pool since the value of this pool, due to its higher exposure to growth assets, will tend to rise more quickly.

In down markets, the medium-term pool will out-perform the long-term pool, so this will be the primary source for replenishing the short-term pool. Periodically rebalancing the overall portfolio back to its agreed strategic asset allocation benchmark would be done using the higher risk long-term pool during periods of strong market returns. **PL**

Endnote: **I** The client will need to apply to their superannuation fund to have their benefit released due to permanent incapacity. The trustee must be reasonably satisfied that the member is unlikely, because of physical or mental ill health, ever again to engage in gainful employment for which the member is reasonably qualified by education, training or experience.

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