

Review of the income tax exemption for structured settlements

Alan Cameron

December 2007

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Review of the operation of the income tax exemption for structured settlements

The Hon Chris Bowen MP
Assistant Treasurer and Minister for Competition Policy and Consumer Affairs
Parliament House
CANBERRA ACT 2600

Dear Minister

I am pleased to present to you the report of the review of the operation of Division 54 of the *Income Tax Assessment Act 1997* and Division 2A of the *Life Insurance Act 1995*, as required by section 54-75 of the *Income Tax Assessment Act 1997*.

I would like to record my thanks to those who took the time and effort to make submissions to the review. In particular, Jane Campbell was very helpful and provided valuable assistance to the review. I would also like to acknowledge the excellent contribution of the secretariat in Treasury.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Alan Cameron'.

Alan Cameron AM

17 December 2007

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EXECUTIVE SUMMARY

My role was to review the operation of Division 54 of the *Income Tax Assessment Act 1997* (ITAA 1997) and related provisions in Division 2A of Part 10 of the *Life Insurance Act 1995* (LIA 1995), and give a report to the Assistant Treasurer. The review was required by section 54-75 of the ITAA 1997.

Division 54 provides an income tax exemption for annuities and deferred lump sums made under structured settlements for people who have suffered a personal injury. Division 2A provides that any commutation or assignment of a tax exempt structured settlement annuity or lump sum is ineffective.

Broadly, a structured settlement is a settlement in which part or all of a damages award or compensation is paid in the form of an annuity to ensure a seriously injured person receives regular payments over their lifetime rather than a one-off lump sum. The tax exemption was introduced in 2002 to encourage the use of structured settlements to compensate accident victims.

The purpose of the review was to assess the effectiveness of the tax exemption and to identify any changes that need to be made to improve its effectiveness. The review was concerned solely with the tax treatment of payments made under structured settlements, consistent with the terms of section 54-75.

The Australian Government introduced amendments into Parliament in 2002 to provide the exemption in response to lobbying from the Structured Settlement Group and others, who argued the tax treatment of annuity payments discouraged accident victims from entering into settlements involving regular payments.

Structured settlements have not been taken up in Australia but not because of their tax treatment. Life insurance companies have not been able to offer lifetime annuities indexed to the All Groups Consumer Price Index (CPI-indexed lifetime annuities) at an attractive price. Also, it seems annuities are not popular products for a number of reasons, including their lack of flexibility and the inability to leave any residual capital as an inheritance for dependants.

Some submissions suggested the exemption should be extended to fixed term annuities, which would be more readily available. However, longevity risk would be borne by the injured person with these products and the purpose of structured settlements, namely to provide an income stream for life, would not be achieved.

Several State Governments argued state insurers should be able to provide annuities from their own funds where the state insurer is the insurer of the defendant in a personal injury compensation claim. It seems to me this issue concerns the boundary of the exemption rather than its operation, and is outside the scope of this review. A number of other issues were similarly not concerned with the operation of the exemption.

In my view there are no changes that can be made to Division 54 that would be likely to increase the use of structured settlements in Australia. However, Division 54 should be retained as it has potential application, including in relation to cases where life expectancy is normal or close to normal.

It seems the investment strategy of placing compensation payments into a superannuation fund and drawing an allocated pension is attractive to many accident victims because it gives them more flexibility than a lifetime annuity regarding payment options, investment choice and access to capital. I would support changes to the superannuation rules to remove any impediments to the use of allocated pensions by all accident victims.

1. THE REVIEW

The Minister for Revenue and Assistant Treasurer, the Hon Peter Dutton MP, announced the review of the income tax exemption provided by Division 54 of the *Income Tax Assessment Act 1997* (ITAA 1997) on 11 September 2007.¹ Division 54 was introduced in 2002 to encourage the use of structured settlements to compensate accident victims. A structured settlement involves regular payments over the lifetime of an injured person rather than a one-off lump sum.

A review of the operation of Division 54 of the ITAA 1997 and Division 2A of Part 10 of the *Life Insurance Act 1995* (LIA 1995), which contains related provisions, was required by section 54-75 of the ITAA 1997. Division 54 provides an income tax exemption for annuities and deferred lump sums made under structured settlements for people who have suffered a serious personal injury. Division 2A provides that any commutation or assignment of a tax exempt structured settlement annuity or lump sum is ineffective.

The purpose of the review was to assess the effectiveness of the tax exemption and to identify any changes that need to be made. The review was concerned to establish whether the income tax exemption provided by Division 54 made structured settlements more attractive for both injured persons and insurers.

Consistent with the terms of section 54-75, the review was concerned only with the tax treatment of payments made under structured settlements and the associated limitations on the ability of a person to assign or commute such payments.

Formal requirements for the review

The requirements for the review are set out in section 54-75:

- The Minister must cause a person to review, and to report to the Minister in writing about, the operation of Division 54 and Division 2A.
- The period to be reviewed started on 19 December 2002, when Division 54 commenced, and ended on 18 June 2007, four years and six months after the commencement.²

¹ See Appendix for media release.

² *Income Tax Assessment Act 1997* (ITAA 1997), subsection 54-75(3).

- A report must be given to the Minister as soon as practicable but no later than 18 December 2007, six months after the end of the review period.³
- The report may include suggestions for changes to the structured settlements and orders provisions that, in the reviewer's opinion, are needed to overcome, or would help overcome, problems identified during the review and set out in the report.⁴
- The public must be given a reasonable opportunity to make submissions.⁵
- A copy of the report must be tabled before each House of the Parliament within 15 sitting days after the Minister receives the report.⁶

3 ITAA 1997, subsection 54-75(4).

4 ITAA 1997, subsection 54-75(5).

5 ITAA 1997, subsection 54-75(6).

6 ITAA 1997, subsection 54-75(7).

2. BACKGROUND TO DIVISION 54

This chapter outlines the concept of structured settlements; the calls for tax exemption for payments made under structured settlements; and the Australian Government's agreement to introduce amendments into Parliament to provide an exemption from income tax.

WHAT IS A STRUCTURED SETTLEMENT?

Structured settlements are a way of paying compensation for personal injury whereby all or part of the compensation is paid in the form of periodic payments funded by the purchase of an annuity.⁷ A structured settlement is a form of settlement agreement that is 'structured' so that the periodic payments are aligned with the financial needs of the injured person over their lifetime.

A settlement agreement arises when the parties to a claim for compensation reach agreement between themselves rather than allowing the matter to proceed through the court process for a court order. Settlement generally will not occur until the condition of the injured person has stabilised, which may not occur until many years after the accident in which the injury was sustained. Court approval is required for settlements involving a person under a legal disability.

The purpose of a structured settlement is to enable people who are injured to receive all or part of their compensation in the form of periodic payments for their lifetime, rather than wholly in the form of a lump sum. A lump sum may be managed ineffectively or dissipated and therefore not result in an adequate income stream for the lifetime of an injured person. Lifetime periodic payments may offer injured people greater long-term financial security than up-front lump sums.

An essential feature of a structured settlement is that the injured person receives the annuity or annuities as part of the settlement agreement. This makes it more likely the injured person will consider financial planning issues before settlement. The annuity is purchased by the defendant or the defendant's insurer from an annuity provider, such as a life insurance company.

⁷ Motor Accidents Authority, *Structured Settlements — Choice and Certainty — Tax reform to facilitate structured settlements*, 1998, pp 9-13; The Structured Settlement Group, *Structured Settlements — A tax reform proposal to benefit accident victims and all tax paying Australians (June 1999)*, 1999, p 3; and The Institute of Actuaries of Australia Structured Settlements Taskforce, 'Structured Settlements in Australia', *Australian Actuarial Journal*, vol 8, issue 3, 2002, pp 397-495.

Structured settlements usually involve a combination of both up-front lump sums and periodic payments. The lump sum component may be needed to pay existing debts, pay legal fees, repay government health and welfare payments, modify a house or purchase special equipment. The claimant may also wish to put conventional investments in place to provide diversification and flexibility.

The periodic payments are designed to meet future expenses such as medical and care costs and living expenses. While the design of a structured settlement might vary according to the total settlement sum and the claimant's individual needs and preferences, a structured settlement would generally include an up-front lump sum of between one-quarter and one-half of the total settlement sum.

The defendant and the defendant's insurer are released from liability under a structured settlement. They have no ongoing relationship with the injured person because the periodic payments are made by the annuity provider directly to the injured person.

Structured settlements have been used in the United Kingdom, Canada and the United States. They received support from the Review of the Law of Negligence (the Ipp Report):

... structured settlements have significant advantages over lump sum compensation, at least in serious cases. Structured settlements are in the interests of plaintiffs because the plaintiff is relieved of the need to manage their compensation. Various studies have shown that where the lump sum award covers a long period, the amount awarded often runs out before the end of that period, even if it is well and wisely invested. A structured settlement provides the plaintiff with a more secure source of income in the longer term. This is good for society generally, as well as for injured persons. It is therefore in the public interest that in cases where large sums of damages are awarded for personal injury or death, the parties have both the opportunity and incentive to conclude a structured settlement.⁸

Example

A 32-year-old man was rendered a quadriplegic in a motor bike accident in the United States.⁹ His bike was hit by a car which failed to stop at a red light. As a result of his injuries his life expectancy was reduced to that of a 47-year-old man (from that of a 32-year-old). The man made a claim against the driver of

8 *Review of the Law of Negligence Final Report (30 September 2002)*, Commonwealth of Australia, Canberra, 2002, paragraph 13.4.

9 The Institute of Actuaries of Australia Structured Settlements Taskforce, 'Structured Settlements in Australia', op. cit., p 404.

the other car for compensation for personal injury. The other driver was insured and the insurance company defended the claim on the driver's behalf.

The parties reached the following settlement agreement. The insurer would pay the man the up-front lump sum amount of \$565,000 to pay his lawyers, pay off his debts and purchase some equipment.

The insurer would also buy the man an annuity that would provide him with monthly payments of \$4,000 (indexed for inflation) for life, and paid for a minimum of ten years whether or not he survived until the end of that period. This monthly sum would cover his medical expenses and living costs for life.

The insurer would also buy the man an annuity providing a series of deferred lump sum payments (a total of eight payments to be paid every five years). After five years he would receive \$25,000, after a further five years he would receive \$75,000, and then he would receive \$100,000, \$150,000, \$250,000, \$350,000 and finally \$500,000. These payments were to be used to meet various expenses, including replacing his wheelchair. These payments were contingent on the man's survival.

CALLS FOR TAX EXEMPTION

Representations were made to the Australian Government for a change to the tax law to exempt annuity payments made under structured settlements from income tax. Proponents argued structured settlements were desirable for large cases involving seriously injured people with long-term medical care needs. They considered the tax treatment of annuities was a disincentive for injured people to consider structured settlements.

Motor Accident Authority

The Motor Accident Authority (MAA) in New South Wales released a report in 1998 seeking changes to the tax laws to encourage the use of structured settlements.¹⁰

The MAA set out the case for structured settlements:

Common law compensation for personal injury developed at a time when modern trauma practices and procedures were not available. Very few people survived with major future care needs. That is no longer the case today.

¹⁰ Motor Accidents Authority, *Structured Settlements — Choice and Certainty — Tax reform to facilitate structured settlements*, op. cit.

The system must provide fair and effective compensation to those requiring care and attention for many years into the future. Many reports have shown that lump sum compensation does not provide the financial security needed by these people.

Structured settlements ... provide far greater financial security for people with future care needs.¹¹

The MAA argued that structured settlements would have significant benefits over lump sum settlements for plaintiffs, defendant insurers, governments and the legal system, but had not been used because of perceived problems with the tax laws:

The primary barrier to the broader use of structured settlements in Australia is the current uncertainty regarding their tax treatment.

At present, if a claimant receives compensation in the form of a lump sum, then it is generally received tax free. However, if a claimant were to receive compensation in the form of periodic annuity payments that were payable for an indefinite period, such as the claimant's life, then it is possible the Australian Tax Office would levy tax on part of each periodic payment.¹²

Structured Settlement Group

The Structured Settlement Group (SSG) was formed in 1999 to further the call for changes to the tax law to assist the adoption of structured settlements. The membership of the SSG included:

- the Australian Plaintiff Lawyers Association, a non-profit association of lawyers and other professionals;
- Injuries Australia, a non-profit NSW-based consumer organisation;
- the Insurance Council of Australia;
- the Law Council of Australia; and
- United Medical Protection, a mutual medical insurance organisation.

¹¹ *ibid.*, p 1.

¹² *ibid.*, p 3.

The SSG made a submission to the Australian Government in June 1999 seeking a tax exemption for annuity payments purchased with personal injury compensation to encourage the use of structured settlements:

Generally speaking, common law lump sum compensation for personal injury is received by a claimant tax free, whereas periodic payments of compensation are subject to income tax. The taxable nature of periodic payments as opposed to lump sums is a strong disincentive to their use in settling common law personal injury claims.

This submission asks the Australian Government to encourage the use of structured settlements by making structured settlement payments of compensation tax free.¹³

The Australian Government was lobbied strongly to provide a tax exemption for structured settlement payments. Prominent in this lobbying effort was Ms Judie Stephens, who joined with the SSG. Ms Stephens was the grandmother of a child who was only three months old when he was orphaned, suffered brain injuries and was paralysed as a result of a car accident in 1993.¹⁴

GOVERNMENT'S AGREEMENT TO TAX EXEMPTION

Announcement on 26 September 2001

The Assistant Treasurer, Senator the Hon Rod Kemp, announced the Government's intention to introduce amendments to encourage the use of structured settlements on 26 September 2001.¹⁵

The Assistant Treasurer acknowledged the role of the Structured Settlement Group:

These arrangements have been developed in consultation with the Structured Settlement Group, which represents a broad range of interested organisations. I am very pleased that we have been able to work so constructively with the SSG to produce an outcome that will benefit some of the most needy in our community.¹⁶

13 The Structured Settlement Group, *Structured Settlements — A tax reform proposal to benefit accident victims and all tax paying Australians* (June 1999), op. cit., p 1.

14 For example, see Helen Beringen, *The Power of One*, *About the House*, March–April 2003, pp 25 and 26.

15 R Kemp (Assistant Treasurer), 'Tax Changes to Encourage The Use Of Structured Settlements For Personal Injury Compensation', media release, Canberra 26 September 2001.

16 *ibid.*

The amendments were expressed to be targeted at seriously injured people who would be reliant on their compensation settlement for the rest of their lives. Annuities were therefore required to provide a minimum level of income support over the annuitant's life to qualify for tax exemption.

Compensation settlements arising from claims against an employer were ineligible for the concession as the measure was intended to benefit seriously injured people who might not otherwise have access to periodic compensation payments. The measure aimed to protect the security of an injured person's income stream by ensuring that annuities were paid from a prudentially regulated source and that they could not be commuted or assigned to another party.

Announcement on 28 March 2002

The Minister for Revenue and Assistant Treasurer, Senator the Hon Helen Coonan, confirmed on 28 March 2002 that, as agreed at a ministerial meeting held the previous day to discuss the problems of rising premiums and reduced availability of public liability insurance, the Government would introduce legislation later in 2002 to encourage the use of structured settlements in personal injury claims.¹⁷

Minister Coonan described the amendments as one of the key steps agreed to at the meeting. Structured settlements could assist in reducing insurance costs by more closely aligning the damages awarded with a person's actual needs, as well as giving injured people greater security about their future income.

Introduction of legislation into Parliament

The Taxation Laws Amendment (Structured Settlements) Bill 2002 was introduced into Parliament on 6 June 2002, containing amendments to provide an income tax exemption for payments made under structured settlements. Minister Coonan said encouraging structured settlements would lead to better outcomes for both injured people and insurers facing large payouts, being one of a range of measures to address public liability problems.¹⁸

17 H Coonan (Minister for Revenue and Assistant Treasurer), 'Structured Settlements a Win-Win', media release, Canberra, 28 March 2002.

18 H Coonan (Minister for Revenue and Assistant Treasurer), 'Government introduces structured settlements legislation', Canberra, 2 June 2002.

3. THE EXEMPTION PROVIDED BY DIVISION 54

This chapter outlines the general taxation of compensation payments; the scope of the exemption provided by Division 54; and the tax benefit provided by the exemption.

General taxation of compensation payments

Lump sums

In many cases compensation paid to injured people consists of an undifferentiated lump sum for loss of earnings, loss of earning capacity, pain and suffering and reimbursement for medical costs. Such lump sums are generally not subject to income tax because they are not income in nature.¹⁹ Nor are they subject to capital gains tax because of a specific exemption for certain compensation or damages receipts.²⁰

However, a lump sum will be taxable if the payment is compensation for loss of income only. A lump sum will also be taxable to the extent that a portion of the lump sum is identifiable and quantifiable as being compensation for loss of income.²¹ This is possible, for example, where the parties agree that a certain portion of the payment relates to a loss of an income nature.

Income earned from the investment of a lump sum, such as interest or dividends, is subject to tax in the normal way.

Annuity payments

The part of an annuity payment that represents the return of the capital used to purchase the annuity (the 'deductible amount') is not taxable. Tax is generally payable, however, on the amount of an annuity payment in excess of the deductible amount, representing the income earned on the capital used to purchase the annuity.²²

For example, say an annuity is purchased for \$500,000 with an interest rate of 5.45 per cent over a period of 20 years. Of the annual payment of \$41,666, only

19 *McLaurin v Federal Commissioner of Taxation* 104 CLR 381.

20 ITAA 1997, paragraph 118-37(1)(b).

21 Taxation Determination TD 93/58.

22 *Income Tax Assessment Act 1936*, section 27H.

\$16,666 is included in the annuitant's assessable income because the deductible amount is \$25,000 for each year (\$500,000/20 years).

Exemption provided by Division 54

Division 54 of the *Income Tax Assessment Act 1997* provides an exemption from income tax for annuities and certain deferred lump sums paid under structured settlements if certain conditions are satisfied. The exemption applies to payments made under structured settlements entered into after 26 September 2001.

Personal injury

Only settlements of claims for compensation or damages for personal injury or illness suffered by the plaintiff fall within the scope of the exemption.²³ Payments to people other than the injured person are not covered by the exemption. Payments relating to claims for loss or damage to property are also outside the exemption. If a claim is both for compensation or damages for personal injury and for some other remedy, the exemption only applies to the compensation or damages for personal injury.

The claim must be based on the commission of a wrong, or a statutory liability.²⁴ The commission of a wrong includes the negligence of another party which gives rise to an action for compensation or damages under common law. Personal injury cases arise mainly from motor vehicle accidents, medical negligence, public liability and product liability.²⁵

Claims against employers and workers' compensation claims excluded

The exemption does not apply in relation to settlements of a claim against the injured person's employer or a claim made under workers' compensation law. Nor does it apply in relation to a claim that could be made under workers' compensation law, for example where a claimant opts out of a workers' compensation scheme and instead pursues a common law claim.²⁶

The Assistant Treasurer explained when announcing the measure that compensation claims arising from claims against an employer would be

23 ITAA 1997, paragraph 54-10(1)(a).

24 ITAA 1997, paragraph 54-10(1)(b).

25 Explanatory Memorandum to Taxation Laws Amendment (Structured Settlements) Bill 2002, paragraphs 1.21 and 1.22.

26 ITAA 1997, paragraph 54-10(1)(c).

ineligible for exemption because it is targeted at ‘seriously injured people who may not otherwise have access to periodic compensation payments’.²⁷

However, the exemption extends to work-related claims other than claims made against the claimant’s employer, such as motor vehicle accident and product liability claims.

Annuity must be purchased by the defendant from a life insurance company or state insurer

Only payments made under an annuity purchased from a life insurance company or a state insurer qualify for exemption. A life insurance company is subject to prudential requirements under the *Life Insurance Act 1995*.²⁸

Moreover, the annuity must be purchased by the defendant or the defendant’s insurer. The exemption does not apply to annuities purchased by the injured person using a compensation payment. Nor does it apply to annuities provided directly by the defendant rather than purchased from a third party.²⁹ For example, an annuity provided directly by a government authority under a settlement of a claim for compensation for personal injury resulting from the negligence of the authority itself would not qualify for exemption.³⁰

Lump sum would have been tax free

An annuity is exempt only if the compensation or damages would not have been taxable if paid as a lump sum at the time of settlement. Accordingly, an annuity purchased from a lump sum awarded for lost earnings would not be exempt.³¹

Frequency and term of payments

The annuity instrument must provide that the annuity payments are to be paid at least annually over a period of at least ten years or for the life of the injured person.³² The minimum ten-year period ensures the annuity is subject to the

27 R Kemp (Assistant Treasurer), ‘Tax Changes to Encourage The Use Of Structured Settlements For Personal Injury Compensation’, op. cit.

28 Explanatory Memorandum to the Taxation Laws Amendment (Structured Settlements) Bill 2002, paragraph 1.34.

29 ITAA 1997, paragraph 54-10(1) (e).

30 Explanatory Memorandum to the Tax Laws Amendment (Structured Settlements) Bill 2002, paragraph 1.34.

31 ITAA 1997, section 54-20.

32 ITAA 1997, section 54-30.

prudential regulation provided by the Australian Prudential Regulation Authority under the *Life Insurance Act 1995*.³³

Kinds of annuities

The annuity instrument may only provide for annuity payments to be increased to maintain their real value by indexation by reference to increases in the All Groups Consumer Price Index or the full-time adult average weekly ordinary time earnings. Alternatively, annuity payments can be increased by a specified percentage.³⁴

Maximum guarantee period

The exemption applies to annuities with a guarantee period of no longer than ten years from the date of settlement. The exemption extends to payments or lump sums paid to the injured person's estate or a reversionary beneficiary under the annuity.³⁵

This condition means an injured person can choose an annuity with a residual value if they die within ten years from the date of purchasing the annuity without losing the benefit of the exemption.

Minimum level of support

The annuity, or where more than one annuity is purchased under a structured settlement, the annuities taken as a whole, must provide a minimum monthly level of support over the injured person's life equivalent to one-twelfth of the standard age pension at the start of the annuity, indexed for subsequent growth in the All Groups Consumer Price Index.³⁶

The Assistant Treasurer explained that a minimum level of support is required because the exemption is targeted at 'seriously injured people who will be reliant on their compensation payment for the rest of their lives'.³⁷

The relevant age pension for the period of the review is set out in the following table.

33 Explanatory Memorandum to the Taxation Laws Amendment (Structured Settlements) Bill 2002, paragraph 1.44.

34 ITAA 1997, section 54-30.

35 ITAA 1997, section 54-35.

36 ITAA 1997, section 54-40.

37 R Kemp (Assistant Treasurer), 'Tax Changes to Encourage The Use Of Structured Settlements For Personal Injury Compensation', op. cit.

Age pension basic rate (single) from 20 March 2001 to 19 September 2007³⁸

Period	Age pension
20 March 2001 to 19 September 2001	10,452.00
20 September 2001 to 19 March 2002	10,673.00
20 March 2002 to 19 September 2002	10,966.80
20 September 2002 to 19 March 2003	11,164.40
20 March 2003 to 19 September 2003	11,447.80
20 September 2003 to 19 March 2004	11,772.80
20 March 2004 to 19 September 2004	12,069.20
20 September 2004 to 19 March 2005	12,238.20
20 March 2005 to 19 September 2005	12,383.80
20 September 2005 to 19 March 2006	12,711.40
20 March 2006 to 19 September 2006	12,992.20
20 September 2006 to 19 March 2007	13,314.60
20 March 2007 to 19 September 2007	13,652.60

Lump sums

A settlement may also provide for the payment of deferred lump sums to meet anticipated expenses, for example, the payment of an indexed amount of \$5,000 every five years for the replacement of a wheelchair for the life of the injured person.³⁹

For a lump sum paid under a structured settlement to be exempt from tax, the settlement must also provide at least one annuity which qualifies for exemption under Division 54 and the lump sum must not have been taxable if paid at the time of settlement.⁴⁰

Commutations and assignments ineffective

Division 2A of Part 10 of the *Life Insurance Act 1995* makes a purported assignment or commutation of an annuity or lump sum ineffective. The

38 This information was provided by the Department of Family, Community Services and Indigenous Affairs.

39 Explanatory Memorandum to the Taxation Laws Amendment (Structured Settlements) Bill 2002, paragraph 1.9.

40 ITAA 1997, sections 54-45 to 54-60.

Assistant Treasurer explained that this requirement is intended to protect the security of an injured person's tax free income stream.⁴¹

Structured orders

The exemption also applies to annuities or lump sums paid under a court order imposed on the parties in respect of a compensation claim for personal injury under which some of the compensation is to be used by the defendant to purchase an annuity to be paid to the injured person. Such an order, called a structured order, needs to be distinguished from a court order that merely endorses a structured settlement agreed to by the parties.

The relevant provisions were included in the Taxation Laws Amendment (Structured Settlements) Bill 2002 as a result of amendments moved by the Government in the Senate. At the time the law was amended to insert Division 54 in the tax law, courts did not have the power to make orders for compensation to be paid in the form of periodic payments. The Government extended the exemption to cover structured settlements made under court orders so that if the States or Territories subsequently amended their laws to enable courts to award structured payments, the supporting Commonwealth legislation would be in place. The Minister for Revenue and Assistant Treasurer explained in the debate on the amendments:

There are cases where a plaintiff wants or needs to take the matter all the way through court to defend his or her rights, to have their day in court. The benefits which a plaintiff or society in general derive from a structured arrangement should not be lost simply because the matter has gone to a hearing.⁴²

The prospect of courts being given the power to impose structured settlements on parties received cautious support from the Review of the Law of Negligence:

The Panel received submissions concerning structured settlements from persons representing the interests of both plaintiffs and defendants. None supported a system under which a court could require the parties to enter into a structured settlement against their wishes. In the circumstances, the Panel makes no recommendation in this regard, although it does believe that careful consideration should be given to the implementation of such a system at some future time.⁴³

41 R Kemp (Assistant Treasurer), 'Tax Changes to Encourage The Use Of Structured Settlements For Personal Injury Compensation', op. cit.

42 Senate Hansard, 5 December 2002, p 7311.

43 *Review of the Law of Negligence, Final Report (30 September 2002)*, op. cit., paragraph 13.3.

State and Territory governments have not given courts the power to make structured orders.⁴⁴ However, they have enacted legislation to ensure courts are able to make consent orders for structured settlements.⁴⁵

Benefit provided by the exemption

The exemption provided by Division 54 provides a benefit to a person receiving an annuity or deferred lump sum to the extent the payments would otherwise be taxable. As discussed earlier in this chapter, only the component of an annuity payment that represents the income earned on the capital used to purchase the annuity is taxable. Division 54 removes the tax on this component of an annuity payment.

Example

A man aged 30 who receives a lump sum compensation payment purchases an annuity for \$1 million with annual payments of \$38,072 for 49 years, the first payment being made on 1 July 2006. Only \$17,664 is included in the man's taxable income because the deductible amount is \$20,408 (\$1 million/49 years).

Assuming the man had no other taxable income, he would qualify for the low income tax offset and his tax liability for 2006-07 would be \$1,150. If the annuity was purchased as part of a structured settlement, the exemption provided by Division 54 would have resulted in a tax saving of \$1,150.

If the man also had interest income of \$35,000 arising from investment of a further \$500,000 received as part of the lump sum, tax payable on his taxable income of \$52,664 would be \$11,149. In this case, the exemption provided by Division 54 would result in a tax saving of \$5,499 if the annuity had been purchased as part of a structured settlement.

44 *Available and affordable — Improvements in liability insurance following tort law reform in Australia*, Commonwealth of Australia, Canberra, 2006, pp 47-53.

45 *Reform of liability insurance law in Australia (February 2004)*, Commonwealth of Australia, Canberra, 2004, pp 93 and 94.

4. STRUCTURED SETTLEMENTS NOT TAKEN UP

Structured settlements have not been taken up in Australia. Many injured people have placed their compensation payments in superannuation and drawn an allocated pension. Others have used conventional investment portfolios to produce an income stream.

This chapter considers the available data concerning claims for compensation for personal injury; the reasons that structured settlements have not been adopted; the perspectives of various parties; the experience in the United Kingdom with structured settlements; and the strategy of using superannuation and allocated pensions.

Failure to take up structured settlements

The review is aware of only one structured settlement made since the tax exemption provided by Division 54 came into effect. This structured settlement was made between South Australia's Motor Accident Commission and one of its claimants.⁴⁶

The Structured Settlement Group suggested the take-up rate overseas was around 30 per cent of large claims.⁴⁷ The review has been unable to obtain comprehensive data on the number of settlements of personal injury claims in the review period of sufficient size to purchase an annuity that would satisfy the minimum monthly level of support requirement of Division 54.

The Australian Prudential Regulation Authority provided data from the National Claims and Policies Database on personal injury compensation claims settled in 2005 and 2006 relating to medical indemnity/malpractice, public liability, mixed public/product liability and product liability. A total of 153 claims greater than \$500,000 were settled during these two years. More information is provided in the table below.

⁴⁶ Government of South Australia's submission to the review of 21 October 2007, p 1.

⁴⁷ The Structured Settlement Group, *Structured Settlements — A tax reform proposal to benefit accident victims and all tax paying Australians (June 1999)*, op. cit., p 14.

Personal injury claims greater than \$500,000 finalised in 2005 and 2006

Class of claim	Excluding court judgments		Including court judgments	
	Number of claims	Average claim cost (\$)	Number of claims	Average claim cost (\$)
Medical indemnity/malpractice	10	1,286,460	10	1,286,460
Public liability	41	782,502	61	871,647
Mixed public/products cover and product liability	102	1,102,483	119	1,063,551
Total	153		190	

The Insurance Council of Australia (ICA) provided data on lump sum settlements of compulsory third party claims in New South Wales and Queensland.⁴⁸ From 2003 to 2006, an average of 89 settlements exceeding \$1 million were made each year, the average lump sum exceeding \$2 million. An average of 236 settlements of \$0.5–1.0 million were made each year during the same period.

The ICA observes the recent establishment of the Lifetime Care and Support Scheme in New South Wales is expected to reduce the number of large compulsory third party claims for motor vehicle accidents. Under this scheme, people severely injured in motor vehicle accidents in New South Wales are provided with treatment, rehabilitation and attendant care services, no matter who was at fault.

Both Victoria and Tasmania have no-fault motor vehicle injury schemes. The Transport Accident Commission in Victoria and the Motor Accidents Insurance Board in Tasmania provide catastrophically injured people with long-term care and support. The ‘future care’ head of damage has been removed from the common law, so that accident victims receiving care under these schemes cannot also claim compensation for future costs. The other heads of damage under common law remain. These schemes are like workers compensation schemes.

There is early anecdotal evidence that the tort law reforms have limited the liability and quantum of damages arising from personal injury. However, the impact of these reforms is not yet certain.⁴⁹

48 Insurance Council of Australia’s submission to the review of 19 October 2007, p 3.

49 *Available and affordable — Improvements in liability insurance following tort law reform in Australia (December 2006)*, op. cit., p 55.

Even though the number of personal injury compensation claims may be reduced by the establishment of no-fault care schemes and the tort law reforms, it is possible that a significant number of claims will continue to be made in the future.

Why haven't structured settlements been adopted?

It seems that CPI-indexed lifetime annuities are not attractive to claimants because they offer a very low return compared with other investment options, even with the benefit of the tax exemption.

Nor are these annuities attractive to insurers because they are more costly than lump sums, especially following the increase in the discount rate from 3 per cent to 5 per cent in New South Wales, Victoria, Queensland and South Australia as part of the tort law reforms.⁵⁰ The discount rate is the factor by which a lump sum for future economic loss or future expenses is reduced to take into account income that would be earned on the lump sum if invested.

The process of agreeing a settlement sum probably involves both parties having regard to the value of a series of notional cash flows relating, for example, to estimated future care costs, reduced by the discount rate. Both parties would be aware that, if they do not reach agreement, the matter will go to court and the court will adopt this approach.

Even if the underlying cash flows are agreed between the parties, the result, after discounting at 5 per cent, will be less (often significantly less) than the amount that a life insurance company would charge to guarantee the same notional cash flow stream. It seems unlikely a defendant would agree to purchase a lifetime annuity from a life insurance company for a certain amount as part of a structured settlement when it knows that, all else being equal, a court would award a lesser amount.

There are other reasons why annuities are unpopular. Annuities are intrinsically inflexible, so people lose control of their capital. The capital does not revert to the injured person's beneficiaries or estate if the person dies earlier than expected. This is a disadvantage for claimants who wish to leave an inheritance to their dependants. Other factors are identified later in this chapter in the context of the experience in the United Kingdom with structured settlements.

These issues are explained in more detail in the following consideration of the perspectives of various parties on structured settlements.

⁵⁰ *Reform of liability insurance law in Australia (February 2004)*, op. cit., pp 92 and 93.

Life insurance companies

Life insurance companies have been unable to offer CPI-indexed lifetime annuities that are attractive to claimants.

The Investment and Financial Services Association (IFSA) explains that lifetime personal injury annuities as contemplated by Division 54 present difficulties for life insurance companies:

... lifetime personal injury annuities are impaired, which means a properly advised injured person will demand a better rate than standard lifetime annuities because of expected higher mortality. It takes a lot of work to determine how impaired they are, which adds to costs for the life insurer, and with higher than normal volatility means a life company needs a big book to make this business worthwhile. For these lifetime personal injury annuities there is both a difficulty in providing appropriate pricing and a volume problem for the life company.⁵¹

The significant differential between a settlement sum and the amount charged by a life company to guarantee the equivalent income stream implied by the settlement sum arises because the guarantee provided by the life company comes at a cost. And the cost of the guarantee is higher where the uncertainty is greater.

In the current context of individuals who are receiving damages relating to personal injury, uncertainty around the life span of an individual is very great. The risk arising from this uncertainty can be reduced significantly if there is a pool of people. The APRA data suggests there would not be a very big pool even if all claimants took a lifetime annuity. No matter how large the pool, some uncertainty will remain.

There is also a lot of uncertainty around future investment returns. The longer the term of the annuity, the more difficult it is for a life company to find assets which match the annuity cash flows.

Only two life insurance companies were in the market for indexed lifetime annuities in Australia in 2003 and 2004.⁵² They based their quotes on the life expectancy for plaintiffs as stated in the Australian Life Tables, making their quotes seem expensive for a person with a reduced life expectancy.⁵³

51 Investment and Financial Services Association's submission to the review of 12 October 2007, p 4.

52 Jane Campbell's submission to the review of 5 November 2007, p 13 of Attachment 1.

53 *ibid.*, p 13 of Attachment 10.

General insurers

The Insurance Council of Australia (ICA) represents the general insurance industry in Australia. The products provided by its members include compulsory third party insurance and insurance for public and product liability. Its members are involved in compensation claims for personal injury where the claims are made against their customers. The ICA's members are not aware that any structured settlements have been used in general insurance claims. 'A common factor cited by insurance companies for not using structured settlements is the lack of suitable products.'⁵⁴

Medical indemnity providers

Avant Mutual Group Limited (Avant) is Australia's largest medical indemnity provider, formed by a merger of United Medical Protection (United) and the Medical Defence Association of Victoria on 1 July 2007. Avant and its predecessors have not used structured settlements in resolving any medical negligence claims. Nor is Avant aware of structured settlements being used by any other medical indemnity providers in Australia.⁵⁵

The increased discount rates have made structured settlements less attractive to insurers because of the increased disparity in cost between the lump sum settlement and an annuity. Avant states the increase in the discount rates reduced the cost of lump sum settlements in major claims by a factor of approximately 20 per cent. In an example cited by Avant, United obtained a quote of \$4,578,882 in May 2001 for an annuity of \$6,000 per week for 20 years to cover home care costs for a woman who suffered a severe brain injury as a consequence of negligent surgery.

Using a 3 per cent discount rate, the cost of the home care component of the damages award was assessed to be \$4,727,400. However, this amount would have been reduced to \$3,998,400 if a 5 per cent discount rate had been used, making a lump sum payment significantly less expensive for the insurer in respect of the home care damages component than purchasing the annuity under a structured settlement.

54 Insurance Council of Australia's submission to the review of 19 October 2007, p 2.

55 Avant Mutual Group Limited's submission to the review of 12 October 2007, p 8.

Lawyers

The Law Council of Australia considers Division 54 has not been successful in encouraging structured settlements.⁵⁶ The Australian Lawyers Alliance,⁵⁷ an association of lawyers and other professionals, believes:

... structured settlements failed because the tax free status of the annuity investments was not enough to outweigh the restrictive nature of the annuities as well as the high cost and low returns of the annuities.⁵⁸

A financial adviser

The experience of Jane Campbell as an adviser in this field supports the view of the Australian Lawyers Alliance. Ms Campbell, formerly Jane Ferguson, was closely involved with the Structured Settlement Group and is now a financial adviser with Ipac Securities Ltd working in the field of personal injury compensation. In 2003 and 2004 Ms Campbell received a number of enquiries from both plaintiff and defendant lawyers concerning the possibility of structured settlements. Quotes for annuities were sought from life companies in five cases but none was accepted. Ms Campbell did not receive any further requests for annuity quotes after April 2004.⁵⁹

Example

A plaintiff lawyer sought advice in 2004 about the possibility of a structured settlement for Tom, a young child who suffered severe injuries as a result of medical negligence. Tom required significant care, therapy and access to specialised equipment, modified accommodation and transport for the rest of his life. Total damages of approximately \$7 million were claimed, including \$4.9 million for future attendant care, on the basis of a normal life expectancy of 74 years.

Quotes were sought from life insurance companies for annuities of various amounts. The best quote for a lifetime CPI-indexed annuity costing \$4.9 million, the amount being sought for future attendant care, provided monthly payments of \$7,943. This was considerably less than the monthly amount of \$20,600 required for future attendant care. A lifetime annuity would not generate the funds required.

The best quote for a lifetime CPI-indexed annuity with a ten-year guarantee period paying \$1,000 per month, which was close to the single basic rate of the age pension (the minimum monthly level of support required by Division 54),

56 Law Council of Australia's submission to the review of 27 November 2007, p 1.

57 Previously the Australian Plaintiff Lawyers Association.

58 Australian Lawyers Alliance's submission to the review of 19 November 2007, at p 1.

59 Jane Campbell's submission to the review of 5 November 2007, at pp 4-6.

was a purchase price of \$619,873. Using financial modelling, a comparison was made between this annuity and a conventional investment of the same amount with annual withdrawals of \$12,000 indexed at 3 per cent, taking commissions and fees into account. An investment return of 7.3 per cent was assumed on the lump sum investment. The annuity payments would be exempt while tax would be payable on investment income.

After ten years, a total of \$137,567 would have been paid under the annuity and there would be no return of capital if Tom died. By contrast, the conventional investment would have provided annual payments and the capital sum would have grown to \$913,942, which would be available to Tom's beneficiaries if he died. At Tom's life expectancy of 74, the total of annuity payments paid would be \$2,960,007 while the capital sum would have reached \$4,814,816. From the perspectives of return on investment and capital value, a lump sum was preferred despite the tax exemption available for the structured settlement.

However, it must be noted that the numbers in this example are sensitive to the assumed rate of investment return. A slightly lower investment return would see the capital sum exhausted before Tom reached 74. It is this sensitivity which makes it difficult for life insurance companies to provide 'competitive' quotes for lifetime annuities.

Structured settlements in the United Kingdom⁶⁰

A new periodical payments regime replaced the previous structured settlements regime in the United Kingdom with effect from 1 April 2005. The courts have been given a discretionary power to make periodical payments orders in any personal injury case involving future loss. Such an order can be imposed on the parties against their wishes. The aim of the new regime is to promote the use of periodical payments in personal injury cases. Periodical payments currently remain the exception and not the rule.

It seems that structured settlements were not widely used. The majority of structured settlements agreed to or awarded were in clinical negligence cases. Certain government departments were permitted to self-fund periodical payments, including the National Health Service Litigation Authority.

The annuity market contracted after 2000, reducing the choice and competitiveness of products available to support structured settlements. Structured settlements became more expensive, so that either they were too expensive for insurers to purchase or the annuity payments were too low for claimants.

⁶⁰ This outline draws on Nicholas Bevan (ed), *Future Loss In Practice: Periodical Payments and Lump Sums*, Butterworths, United Kingdom, 2007, paragraphs 2.21-2.39.

Reasons for structured settlements not being taken up in the United Kingdom include:

- concerns that periodic payments were not sufficiently inflation-proofed when linked to a price-linked index rather than an earnings-linked index;
- the desire for finality;
- the available rate of return on capital investments;
- the loss of opportunity to invest; and
- the restriction on the claimant's freedom of action to deal with the compensation payment.⁶¹

The use of superannuation and allocated pensions

Jane Campbell suggests that while CPI-indexed lifetime pensions are not attractive to claimants, the superannuation system offers them a useful alternative investment structure.⁶² Claimants able to meet the permanent incapacity condition of release by virtue of their injuries could contribute their compensation funds into superannuation and then roll over the funds to commence an allocated pension. People who could not, or who did not want to, use superannuation instead used other investment strategies to produce an income stream.

Allocated pensions are attractive to claimants because they:

- deliver a regular income stream;
- offer flexible payment options concerning the amount and timing of payments;
- provide investment choice. Market-linked or asset-linked annuities, which give a higher return, can be chosen;
- provide access to capital, including lump sum withdrawals;
- are available to a plaintiff's estate or beneficiaries in the event of the plaintiff's death;
- are a commonly used investment vehicle that is easily understood and widely available;

⁶¹ *ibid.*, paragraphs 2.37 and 2.38.

⁶² Jane Campbell's submission to the review of 5 November 2007, pp 7 and 8.

- are relatively inexpensive to establish and administer; and
- are fully commutable so they can be taken as a lump sum. People are not 'locked in'.

To place their compensation payment into a superannuation fund and then immediately draw an allocated pension to provide an income stream, injured people must be eligible to contribute to superannuation and satisfy the condition for release of total and permanent disability in order to access their funds. Before 1 July 2004, a work test had to be satisfied in order to make a contribution to superannuation. A work test still applies for people aged 65 to 74.

The taxation of allocated pensions is attractive to injured people. Investment earnings on the assets supporting an allocated pension (which make up the pension account balance) are exempt from tax at the level of the fund. While payments from an allocated pension are included in assessable income for people under the age of 60, the component of a payment which represents the return of the capital used to purchase the pension is not taxable.⁶³ In addition, in the case of disability pensions a 15 per cent rebate is allowable on the taxable part of pension payments. A minimum amount of 4 per cent of the account balance must be withdrawn each year. This percentage varies with the age of a person.

This strategy continues to be attractive for injured people following significant reforms made to the taxation of superannuation from 1 July 2007. There is, in effect, no limit on the amount of a compensation payment that can be placed into superannuation. In addition, payments from income streams purchased solely with after-tax monies are entirely tax free regardless of the age of the recipient. Of course, whether this strategy is appropriate for a person will depend on their particular circumstances and it remains advisable for injured people to obtain financial advice before making decisions in relation to compensation payments.

63 Allocated pensions are taxed in the same way as annuities. See Chapter 3.

5. SUBMISSIONS TO THE REVIEW

This chapter outlines the issues raised in the 14 submissions made to the review.

Australian Medical Association

The Australian Medical Association gives broad support to a tax exemption for structured settlements.⁶⁴

Avant Mutual Group Limited

Avant Mutual Group Limited, a medical indemnity provider, considers there should be no change to the exemption provided by Division 54 for structured settlements. It believes structured settlements could be useful in cases where life expectancy is normal or close to normal.⁶⁵

Cumpston Sarjeant Pty Ltd

Richard Cumpston of Cumpston Sarjeant Pty Ltd, a firm of consulting actuaries which helped prepare some of the submissions seeking a tax exemption for structured settlements, suggests the tax exemption be replaced by a fund established by the Australian Government to provide lifetime annuities to injured people on a break-even basis. Alternatively, Mr Cumpston suggests injured people could be given a broad tax exemption for income arising from the investment of compensation payments, similar to the exemption for the superannuation of people aged over 60.⁶⁶

Government of the Australian Capital Territory

The Australian Capital Territory Department of Treasury considers tax free status should be extended to arrangements under which personal injury compensation payments are held on behalf of an injured person by a Public Trustee. This change would make income earned on the capital amount and payments made to the injured person exempt from tax.⁶⁷

64 Australian Medical Association's submission to the review of 25 October 2007, p 1.

65 Avant Mutual Group Limited's submission to the review of 12 October 2007, p 8.

66 Cumpston Sarjeant Pty Ltd's submission to the review of 11 September 2007, p 1.

67 Australian Capital Territory Department of Treasury's submission to the review of 19 October 2007, p 2.

Government of South Australia

The Government of South Australia considers the following annuities should not be excluded from tax exemption under Division 54:

- annuities provided directly to injured persons by state insurers whose liabilities are guaranteed by the State government, such as the South Australian Government Financing Authority and the Motor Accident Commission, because this would be administratively simpler than purchasing an annuity from another party;
- annuities purchased by a claimant; and
- annuities that allow assignment of the annuity to an approved service provider.⁶⁸

To avoid uncertainty about whether certain government bodies are state insurers for the purpose of the exemption under Division 54, the Government of South Australia suggests state insurers should be specified in the law.

The Government of South Australia also considers tax free treatment should be given to arrangements made by state insurers under which accommodation and support services are provided to injured persons instead of giving them an annuity to fund such services, so that payments to the providers would be exempt from tax.

Government of Tasmania

Tasmania's Department of Treasury and Finance considers state insurers should be able to provide annuities from their own funds where the state insurer is the insurer of the defendant in a personal injury compensation claim:

Some state insurers are the entities best placed and most likely to introduce such arrangements ... the most practical way for such insurers to introduce structured settlements is to provide them from their own funds rather than by purchase from a life insurance company ...⁶⁹

It also supports tax exemption being extended to payments made to service providers under a structured settlement.

⁶⁸ Government of South Australia's submission to the review of 21 October 2007, pp 2 and 3.

⁶⁹ Tasmania's Department of Treasury and Finance submission to the review of 10 October 2007, p 2.

Government of Victoria

Victoria's Department of Treasury and Finance argues that the exemption should be extended to annuities made under structured settlements relating to workers compensation claims. Like the Government of South Australia and Tasmania's Department of Treasury and Finance, it also considers exemption should be extended to annuities provided by state insurers.⁷⁰

Insurance Council of Australia

The Insurance Council of Australia (ICA) considers Division 54 remains 'an important and necessary instrument to ensure the attractiveness of structured settlements'.⁷¹ It suggests structured settlements have not been more successful because the structured settlements market is not competitive and suitable products have not been available.

The ICA recommends the current exemption for lifetime annuities made under structured settlements should be widened to allow fixed term annuities of 10- to 14-year terms. These fixed term annuities would have a residual capital value so they could be 'rolled over' to another fixed term annuity. This approach would remove the problem of long-term interest rate uncertainty currently faced by annuity providers in relation to lifetime annuities, which the ICA considers is a constraint on the provision of such annuities.

Investment and Financial Services Association

The Investment and Financial Services Association (IFSA) believes the exemption should be retained but the existing requirements of Division 54 are too restrictive.⁷² IFSA argues the current exemption should be extended to cover products that would be easier for life insurance companies to provide. Firstly, IFSA suggests exemption should be extended to fixed term life expectancy annuities with an adjustment to the life expectancy tables to reflect a person's reduced life expectancy, for instance by adding ten years to the injured person's actual age.

However, such annuities would leave the injured person with some longevity risk. In recognition of this problem, IFSA suggests the exemption should also be extended to fixed term residual capital value annuities of more than ten years. Such an annuity could be rolled over into another one at the end of its term, allowing the injured person to manage their longevity risk.

70 Victoria's Department of Treasury and Finance submission to the review of 16 October 2007, pp 1 and 2.

71 Insurance Council of Australia's submission to the review of 19 October 2007, p 6.

72 Investment and Financial Services Association's submission to the review of 12 October 2007, pp 1 and 2.

IFSA considers the exemption should also be extended to:

- payments from a superannuation income stream;
- periodic payments from special purpose trusts;
- death benefits; and
- periodic payments made under insurance contracts for injury or illness.

Jane Campbell⁷³

Jane Campbell considers structured settlements have failed in Australia and the exemption could be removed.⁷⁴ Ms Campbell suggests the allocated pension rules could be amended to enhance their application in cases involving the seriously injured. These changes would include allowing a minimum pension of less than 4 per cent for children; clarifying the operation of the permanent incapacity condition of release in relation to people, including children, who have never worked; and allowing people aged over 65 who do not meet the work test to make contributions into superannuation.⁷⁵

Australian Lawyers Alliance

The Australian Lawyers Alliance, formerly the Australian Plaintiff Lawyers Association, supports Jane Campbell's view that the superannuation rules should be reviewed to ensure injured people of all ages can use allocated pensions in conjunction with superannuation.⁷⁶

Law Council of Australia

The Law Council of Australia considers the exemption should be extended to cover a wider range of financial products, including allocated pensions.⁷⁷

⁷³ See Chapter 4 for information about Jane Campbell.

⁷⁴ Jane Campbell's submission to the review of 5 November 2007, p 1.

⁷⁵ *ibid*, pp 1 and 8.

⁷⁶ Australian Lawyers Alliance's submission to the review of 19 November 2007, p 1.

⁷⁷ Law Council of Australia's submission to the review of 27 November 2007, p 1.

Royal Australasian College of Surgeons

The Royal Australasian College of Surgeons gives broad support for the concept of structured settlements and any measures that make them easier to implement.⁷⁸

Trustee Corporations Association of Australia

The Trustee Corporations Association of Australia criticises the requirement that an annuity must be purchased by the defendant's insurer on the basis it gives the defendant or defendant's insurer unfair leverage in the bargaining process. It encourages 'maximum flexibility and the avoidance of unnecessary complexity in structured settlement arrangements'.⁷⁹

⁷⁸ Royal Australasian College of Surgeons' submission to the review of 18 September 2007, p 1.

⁷⁹ Trustee Corporations Association of Australia's submission to the review of 12 October 2007, p 1.

6. CONCLUSION AND RECOMMENDATIONS

Structured settlements as provided for by Division 54 have not been taken up in Australia. However, there remains general agreement that periodical payments would have advantages over lump sum settlements for people with serious injuries with long-term income needs.

The failure of structured settlements is not due to their tax treatment. It is unlikely the tax treatment of annuities was the primary obstacle to structured settlements before a tax exemption was provided by Division 54.

Life insurance companies have not been able to offer CPI-indexed lifetime annuities at an attractive price. There are other reasons lifetime annuities may not appeal to accident victims. The capital is lost if the injured person dies after the maximum guarantee period of ten years but earlier than expected, so that it cannot be left as an inheritance for dependants. The injured person also loses the freedom to deal with the lump sum. It is noteworthy that structured settlements are not widely used in the United Kingdom.

In my view there are no changes that can be made to Division 54 that would be likely to increase the use of structured settlements in Australia while retaining their essential feature of ensuring seriously injured people receive regular payments at least equal to the age pension over their lifetime instead of a one-off lump sum.

However, I would support changes to the superannuation rules to remove any impediments to the use of allocated pensions by all accident victims, including children, people aged over 65 and people who have not worked. The investment strategy of placing compensation payments into a superannuation fund and drawing an allocated pension is attractive to many accident victims because it gives them more flexibility than a lifetime annuity regarding payment options, investment choice and access to capital. Equity demands this option should be made available to all injured people.

I have not made a recommendation in relation to this proposal because it is outside the scope of this review, which is confined to the tax treatment of payments made under structured settlements.

Recommendations

I recommend Division 54 be retained.

Given that the tax exemption provided by Division 54 has not resulted in the use of structured settlements in Australia, and the lack of any prospect they will be used on a regular basis in the future, there is a case for repealing Division 54 (and the related provisions in the LIA 1995). If Division 54 was repealed, a savings provision of some kind would be required to preserve tax exempt treatment on an ongoing basis for those, apparently few, structured settlements entered into while Division 54 was in force.

However, I believe Division 54 should be retained while it has any potential application. Market conditions may change, so that life insurance companies quote for CPI-indexed lifetime annuities on the basis of reduced life expectancies. It is possible that discount rates for lump sums may be reduced in the future, making lump sum settlements less attractive to insurers. I note Avant Mutual Group Limited believes structured settlements could be useful in cases where life expectancy is normal or close to normal. Retaining Division 54 would not have any negative consequences as there is no suggestion the exemption can be, or has been, misused.

I recommend tax exemption not be extended to fixed term annuities with a residual capital value.

The Insurance Council of Australia and the Investment and Financial Services Association suggest the exemption should be extended to fixed term annuities with a residual capital value with terms greater than ten years, which could be rolled over into another annuity on expiry. These products could be readily provided by life insurance companies.

Under this approach, longevity risk would be borne by the injured person rather than the annuity provider. An injured person would not be assured of an income stream at least equal to the age pension for their lifetime, whereas a lifetime annuity provides certainty in this regard. Extending exemption to these products would be inconsistent with the concept of structured settlements as contemplated by Division 54, which is to provide an income stream for an injured person's lifetime.

I recommend that tax exemption not be extended to annuities that allow assignment of the annuity to an approved service provider.

The purpose of structured settlements is to ensure an injured person receives an income stream for their lifetime. Extending exemption to annuities that could be assigned to service providers would undermine this purpose. An injured person who assigned their annuity to a service provider in exchange for accommodation and support services would lose their income stream but could not be certain the service arrangement would continue for their lifetime.

Assignment of annuities would introduce complexities in providing for circumstances where there were changes to the required level of care, including where care was no longer needed, or to care arrangements. Problems could also arise if an injured person wished to change their care provider.

I recommend state insurers be specified in the law to avoid uncertainty about whether certain government bodies are state insurers for the purpose of the exemption under Division 54.

This technical change to the provisions would remove any uncertainty that might otherwise arise. Annuities qualifying for exemption under Division 54 may be purchased from a life insurance company or a state insurer. The Government of South Australia advises that tax rulings were required to clarify whether South Australia's Motor Accident Commission and the South Australian Government Financing Authority were state insurers for the purpose of Division 54.

Proposals made in submissions outside the scope of the review

Some proposals made in submissions to the review do not relate to structured settlements. A number of other proposals relate to structured settlements but are concerned with widening the scope of the exemption intended by Parliament rather than the operation of the exemption itself. These proposals are outside the scope of this review, which is concerned with the operation of Division 54 of the ITAA 1997 and Division 2A of Part 10 of the LIA 1995, and I do not make any recommendations in relation to them. However, I have noted these proposals and made some observations on those that relate to structured settlements.

Extend tax exemption to annuities self-funded by state insurers

The Government of South Australia, Tasmania's Department of Treasury and Finance and Victoria's Department of Treasury and Finance argue the exclusion of annuities provided by state insurers is inequitable. However, they do not suggest that state insurers have not provided lifetime annuities under structured settlements because of this treatment.

The exclusion of annuities provided directly from their own funds by state insurers by the requirement that an annuity must be purchased from a life insurance company or a state insurer is a deliberate feature of Division 54.⁸⁰ It does not affect the operation of the exemption but merely places a boundary on its operation.

⁸⁰ For example, see Example 1.3 in the Explanatory Memorandum to the Tax Laws Amendment (Structured Settlements) Bill 2002, p 11.

Remove exclusion of structured settlements relating to workers compensation claims

Structured settlements relating to workers compensation claims are expressly excluded from the exemption provided by Division 54.⁸¹ The Assistant Treasurer explained when he announced the Government's intention to introduce legislation into Parliament to provide a tax exemption for structured settlements that settlements arising from claims against an employer were not intended to be eligible for the exemption.⁸²

Extend tax exemption to payments by state insurers to approved service providers as part of a structured settlement

Division 54 is concerned with providing tax exemption for income streams for injured persons. It is not clear how this proposal would assist injured people.

Proposals that do not relate to structured settlements

The following proposals, on which I make no further comment, do not relate to structured settlements:

- amend the superannuation rules to ensure injured people of all ages can use allocated pensions in conjunction with superannuation;
- extend tax exemption to annuities purchased by a claimant from a lump sum settlement;
- establish a federal fund to provide lifetime annuities to injured people;
- extend tax exemption to the income of injured people arising from the investment of their compensation payments;
- extend tax exemption to public trustees in respect of personal injury compensation payments; and
- extend tax exemption to payments from a superannuation income stream, periodic payments from special purpose trusts, death benefits and periodic payments made under insurance contracts for injury or illness.

81 ITAA 1997, paragraph 54-10(1)(c).

82 R Kemp (Assistant Treasurer), 'Tax Changes to Encourage The Use Of Structured Settlements For Personal Injury Compensation', op. cit.

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**PETER DUTTON
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Press Release No. 109

Tuesday, 11 September, 2007

**REVIEW OF INCOME TAX EXEMPTION FOR
STRUCTURED SETTLEMENTS PAYMENTS**

The Minister for Revenue and Assistant Treasurer, Peter Dutton, today announced a review of the income tax exemption provided by Division 54 of the *Income Tax Assessment Act 1997* for payments made under structured settlements to seriously injured people.

‘The purpose of the review, which is a statutory requirement, is to assess the effectiveness of the tax exemption and to identify any changes that need to be made,’ Mr Dutton said.

Division 54 was introduced in 2002 to encourage the use of structured settlements to compensate accident victims. A structured settlement involves regular payments over the lifetime of the injured person rather than a one-off lump sum. Structured settlements offer injured people more security about their future income and their capacity to meet ongoing medical expenses.

The review will examine the operation of Division 54 and also Division 2A of Part 10 of the *Life Insurance Act 1995*, which contains related provisions. It is concerned with the tax treatment of payments made under structured settlements and the associated limitations on the ability of a person to assign or commute such payments.

Mr Alan Cameron AM will undertake the review.

Mr Cameron has extensive experience in both the public and private sectors. He was chairman of the Australian Securities Commission and its successor, the Australian Securities and Investments Commission, from 1993 to 2000.

‘Alan Cameron has been involved in regulatory projects and governance reviews of various kinds since 2000. He holds a number of directorships and consultancies, which broaden the experience he brings to the review,’ Mr Dutton said.

Mr Cameron is chairman of two life insurance companies. Neither company sells annuities to accident victims.

The review will be supported by a small secretariat in Treasury.

Mr Cameron is inviting submissions from the public about matters relating to the operation of Division 54 *Income Tax Assessment Act 1997* and also Division 2A, Part 10 *Life Insurance Act 1995*.

Submissions are due by 12 October 2007 and may be sent by email to division54@treasury.gov.au or posted to:

Review of Division 54 Secretariat
The Treasury
Langton Crescent
PARKES ACT 2600

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