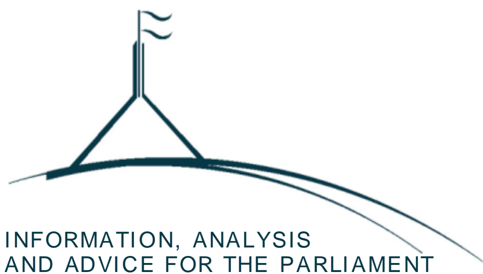

INFORMATION AND RESEARCH SERVICES

Bills Digest
No. 20 2002–03

Taxation Laws Amendment (Structured Settlements) Bill 2002

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Taxation Laws Amendment (Structured Settlements) Bill 2002

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Law and Bills Digest Group
19 August 2002

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Taxation Laws Amendment (Structured Settlements) Bill 2002

Date Introduced: 6 June 2002

House: House of Representatives

Portfolio: Treasury

Commencement: Royal Assent. However the measures contained in the Bill will apply to settlement made on or after 26 September 2001.

Purpose

To provide a tax exemption for monies received from certain annuity and lump sums that are received as part of a structured settlement for personal injury claims.

Background

'Structured settlements' refers to the position where a seriously injured person receives periodic payments rather than a lump sum as compensation for their injuries. The term also covers the situation where part of the compensation is paid as an initial or later lump sum with the remainder being received in periodic payments. The periodic payments usually come in the form of an annuity purchased by the defendant insurer.

History

While the move to the adoption of structured settlements as a possible alternative to lump sum damages has received considerable publicity due to recent events regarding medical practitioner insurance liability coverage, the proposal has a longer history. Structured settlements were adopted by the USA and Canada in the 1970s and were adapted by the UK in 1987, following changes to its tax laws. The first UK structured settlement case was settled in 1989. While the matter had been discussed earlier, encouraging the use of structured settlements in Australia began to be more seriously considered in the mid and late 1990s.

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In 1995, the Review of Professional Indemnity Arrangements for Health Care Professionals, conducted by the Department of Health, recommended that the government take urgent action to amend the tax law to encourage the use of structured settlements.[1] (Taxation is the main obstacle to structured settlements in Australia, see below). In 1996 and 1997 the NSW Law and Justice Committee and the Victorian Law Reform Committee both recommended that structured settlements be encouraged by changes to the tax laws.[2] The NSW Motor Accident Authority in 1998 prepared a comprehensive report on the issue, including financial modelling and a financial impact report which stated that, based on various assumptions, their adoption would save Federal and State funds.[3] The report recommended that structured settlements be assisted through changes to the tax law and their report was subsequently referred by the State government to the Federal government. Reportedly the response from the Federal government was 'essentially no.' and 'that people should choose them regardless of the tax law.'[4]

For further information on the history of structured settlements refer to:

http://www.structuredsettlements.com.au/history.htm

Proposals

The Structured Settlement Group (SSG) was subsequently formed in January 1999 and consists of the Australian Plaintiff Lawyers Association, Law Council of Australia, Injuries Australia, Insurance Council of Australia and United Medical Protection (the Australian Medical Association joined in November 1999). SSG was established to continue lobbying for changes to the tax law to assist the adoption of structured settlements. A major lobbying effort was made in June 1999 with a media launch of the proposal previously put to the government and other parties. SSG was hopeful that tax changes would be announced in the 2000-01 Budget but this did not occur. Following the delivery of the Budget on 9 May 2000 a spokesperson for the Assistant Treasurer is reported, on 13 May 2000, as stating that the government had yet to reach a decision on the matter and that 'This is a complicated issue. It is a difficult one and needs to be looked at very carefully.'[5]

However, lobbying and consultation continued and on 21 September 2001 the Assistant Treasurer announced that tax free settlements would be allowed where certain conditions were met. The Assistant Treasurer stated that the arrangements had been developed in consultation with SSG and that they would have affect from the day of the announcement.[6]

Public Liability Insurance

Structured settlements next received attention in relation to recent increases in public liability insurance and medical insurance. Significant reaction from community groups, the medical profession and the media to the impact of, in some cases, substantial increases in public liability and professional insurance, led to calls for government action to curtail

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the increases or to act to indemnify the industry from the increased costs. The later course was followed by the medical profession which threatened a substantial loss of service from its members unless the government acted to guarantee certain liabilities following the appointment of a provisional liquidator to one of the main medical insurance companies.[7]

While there has been a variety of responses from the Federal, State and Territory governments, the need for a unified response from the various governments was seen as essential for a unified approach which could clarify various matters Australia wide. The first reflection of a unified governments response was the Ministerial Meeting on Public Liability held on 27 March 2002. The meeting comprised Commonwealth, State and Territory Ministers from various portfolios and the President of the Local Government Association. The Joint Communique from the meeting noted an expert report received by the meeting from a consultant which identified major factors behind rising public insurance premiums increasing and being denied to certain areas as:

- Changing community attitudes to litigation
- Changes in the courts' view of what constitutes negligence
- Increased compensation payments for bodily injury claims
- Past under-pricing and poor profitability of the insurance industry
- The collapse of HIH, a major player in the public liability market, and
- A decision by insurance companies to be more selective about the risks that they cover.[8]

As part of the measures proposed to address this situation the Ministers agreed to (the announced) taxation law changes to encourage structured settlements. The Joint Communique states:

> The Commonwealth will introduce legislation to make tax changes to encourage the use of structured settlements for personal injury compensation,
>
> The States and Territories will make such legislative changes as are necessary to remove the barriers to structured settlements as an alternative to lump sum payouts.[9]

In a Press Release released the next day the Minister for Revenue and the Assistant Treasurer made a number of points regarding structured settlements, including:

- Structured settlement can assist in reducing insurance costs by more closely aligning the damages awarded with a person's actual needs
- Under the current system there were cases of windfall payouts which were much larger than necessary because of the uncertainty surrounding a claimant's future medical needs, and

- The legislative changes would give the courts freedom to make a structured settlement order which will better meet the needs of catastrophically injured people.[10]

In this regard it is worth noting the role that future medical expenses can play in large damages awards. In a relatively recent case of medical negligence during birth it was reported that the plaintiff was awarded approximately $13 million, including $6.518 million for future medical expenses.[11]

It is also worth noting that the role of compensation in negligence cases at common law is to place the injured person, as far as possible, in the same position that they would have been had the negligence not occurred. This includes financial compensation for medical expenses and loss of future income. It is not currently the role of damages to provide only what is necessary to maintain life.

Pros and Cons of Structured Settlements

The following is based on the assumptions that structured settlements are optional, that most of the damages awarded are used to purchase an annuity from a life insurance company which will make periodic payments to the injured person and the injured person has substantial injuries which will require on-going medical treatment for life.

Advantages:

- The opportunities for the injured person to dissipate a large amount on items unrelated to their medical needs, such as through gifts to friends and relatives, are substantially removed

- Payments will continue for life even if this is longer than the time expected in the calculation of damages

- The injured person, or their representatives, do not bear the risks of investing the lump sum being guaranteed a certain amount usually adjusted for inflation

- In addition to presumptions about an injured persons expected lifespan (usually based on actuarial tables), when calculating the damages to be awarded certain assumptions must also be made about the future value of award made. These usually involve assumptions such as the future cost of medical treatment, rate of inflation and investment returns. Under a structured settlement regime the injured person is less affected if the assumptions made turn out to be against their interests through, for example, lower rates of investment returns than those assumed. (However, the life insurance company issuing the annuity will have made a number of similar assumptions when determining the price of the annuity), and

- Under the proposals contained in the Bill the income from an annuity purchased through a structured settlement will be tax exempt. However, income from the

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investment of a lump sum will be subject to tax (with the amount of capital involved in some cases the income from investments may result in the highest marginal rate being payable).

Disadvantages

- If the injured person dies early there will be a gain for the issuer of the annuity, rather than the beneficiaries of the deceased. Annuities may contain a provision allowing them to continue for a certain period after the death of the injured person but this is very unlikely to still prevent the gain to the annuity issuer
- The issue of the annuity involves an up-front profit to the issuer at a cost to the insured as part of the issuer's business
- If the actual investment returns are greater than those assumed in the award of damages the injured person will not be able to take advantage of this, and
- If the damages awarded are invested well there is the possibility that there may be a substantial sum to be left by the injured person after their death which will not occur with an annuity.

Taxation Situation

The current tax treatment of compensation payment rests on two principles: that a capital sum is not taxable and that payments in lieu of income are taxable in the same manner as the income replaced. The most simple examples of this are that a payment of the loss of ability to earn future income is a capital amount to compensate for the loss of capital (ie the ability to earn future income) while a payment directly to replace wages, such as periodic workers compensation payments, are taxable as income. The relevant provisions of the *Income Tax Assessment Act 1936* (ITAA36) are s. 25(1) which contains the general definition of income and paragraph 26(j) which provides that assessable income is to include any amount received by way of insurance or indemnity for a loss of profit or income which would have been assessable income if the loss had not occurred. The logic behind the inclusion of such payments as assessable income is that they replace income that otherwise would have been taxable and so to place all the parties in the same position, tax is payable on the replacement income.

In practice, however, the distinction between whether a payment is capital or income is often not clear and in determining if a payment is taxable or not the Courts will have regard to the nature of the payment and, if it is paid under a statutory scheme, the purpose of the payment as outlined in the statute. If a payment is of a periodic nature this will suggest that it is a substitute for income but is not conclusive as a periodic payment can also be a part payment of a capital amount. If a payment is considered to be a capital amount and so not subject to tax, this is usually reflected in the calculation of the amount of damages available so that the

person is placed as near as possible in the same position, after tax, as they would have been had the accident not occurred.

In regard to interest payments awarded by the courts, both pre-judgement (for the period from the day the cause of action occurs until the time of judgement) and post-judgement interest (from the time of judgement until the time of payment of damages) are tax exempt (section 23GAA of the ITAA36). Currently both the income received from an annuity and from the investment of a lump sum damages award are subject to tax under the ordinary definition of income.

Cost

The explanatory memorandum to the Bill estimates the tax exemptions will cost $1.4 million in 2002-03, $2.5 million in 2003-04, $3.6 million in 2004-05 and $4.6 million in 2005-06. It also estimates that the cost will rise to approximately $20 million per year after roughly 20 years and stabilise at that level. In contrast, studies done by the proponents of structured settlements have found that if the savings to welfare support for people who would otherwise have used-up their lump sum and so require welfare support is taken into account there would be savings to governments. The SSG found, based on a study by Coopers and Lybrand commissioned by the Motor Accident Authority (MAA), that with a take up rate of 100% for settlements over $100 000 there would be a net saving to government of approximately $219 million and that with a take up rate of 30% the net saving would be over $60 million.[12]

It has also been found that there should be savings for insurance companies, with the MAA finding:

> Overseas, defendant insurers have estimated that the savings made by using structured settlements range generally from 8 to 15 per cent of the cost of equivalent lump sum settlements.[13]

Main Provisions

Item 1 of Schedule 1 of the Bill will insert a **new Division 54** into the *Income Tax Assessment Act 1997* (ITAA97). Structured settlement is defined in **proposed section 54-10** and will be a claim that:

- is for compensation or damages for personal injury
- is made by the insured person or their legal personal representative
- is based on a wrong or right created by statute, and
- is not made against an employer or an associate of an employer and is not made under a workers compensation law or as an alternative to such a claim.

And the settlement of the claim:

- takes the form of a written agreement between the parties, whether this is endorsed by a court or not
- involves some or all of the compensation or damages being used to purchase from a life insurance company or a State insurer:
  - an annuity or annuities to be paid to the injured person or their trustee for the benefit of the injured person, or
  - such annuities together with the payment of one or more lump sums that are paid to the injured person or their trustee.

If the damages/compensation claim involves both personal injury and property or other damages, the structured settlement can only apply to the personal injury component of the claim (**proposed subsection 54-10(3)**).

Proposed subdivision 54-B deals with the tax exemption for structured settlement annuities. **Proposed section 54-15** provides that such annuities will be exempt if the conditions in the subdivision are satisfied. The conditions are:

- if the damages or compensation used to purchase the annuity had been paid as a lump sum it would have been tax exempt (**proposed section 54-20**), and
- the instrument granting the annuity must:
  - identify the structured settlement under which it is made
  - allow payments only to the injured person, their trustee or as part of an allowable revisionary benefit (see below) (**proposed section 54-25**),
  - provide for payments at least annually for a minimum of 10 years
  - specify the first date of payment and, if it lasts for a fixed number of years, the date of the final payment
  - specify the amount of each periodic payment
  - only allow payment increases in line with movements in the consumer price index (CPI), average weekly earnings or a percentage specified in the instrument (**proposed section 54-30**).

Proposed section 54-35 allows for the annuity to continue after the death of the injured person in certain circumstances:

- the annuity instrument may provide for revisionary benefits for a maximum of 10 years after the date of settlement (ie when the structured settlement comes into force)

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with the benefits to be payable to either the deceased persons estate or a revisionary beneficiary

- if the payment is to made to a revisionary beneficiary that beneficiary must be named in the annuity instrument and allow them to chose either a continuation of the benefits that the injured person would have received or to commute these payments to a lump sum
- the injured person's estate may only be paid the lump sum, and
- in calculating any lump sum payment any increase in the payments after the time of death are to be ignored.

As well, the annuity, or annuities, must satisfy the minimum monthly level of support requirements contained in **proposed section 54-40**. For the first year of the annuity this will be the basic rate of aged pension payable to the injured person under the *Social Security Act 1991* (which will depend on whether they are single or have a partner) and the amount of the person's pension supplement if that were payable. For later years the minimum amount will be the amount calculated for the first year multiplied by the social security indexation factor (which is based on movements in the CPI) or the amount calculated by reference to their social security rates for the year.

Lump sums paid under a structured settlement will also be exempt if the conditions in **proposed subdivision 54-C** are satisfied. Such a lump sum must be made in addition to an annuity that satisfies the conditions to be tax exempt (**proposed section 54-45**) and:

- would have been an exempt payment if the funds used to purchase the annuity package under which it is payable would have been tax exempt if paid as a lump sum (**proposed section 54-50**), and
- the instrument under which the lump sum is paid must:
  - identify the structured settlement of which it is a part
  - only allow for the lump sum to be paid to the injured person or their trustee
  - contain a statement that the lump sum cannot be assigned, commuted or otherwise cashed–out early (**proposed section 54-55**)
  - specify the date and amount of the payment of the lump sum, and
  - only allow payment increases in line with movements in the consumer price index (CPI), average weekly earnings or a percentage specified in the instrument (**proposed section 54-60**).

Miscellaneous matters are dealt with in **proposed subdivision 54-D**. Revisionary benefits will be exempt so log as they comply with proposed section 54-35 (**proposed section 54-65**). Income of a trust will be exempt if the amount would be exempt if received by the injured person or revisionary beneficiary (**proposed section 54-70**).

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The Minister is to arrange a review of the operation of the proposed amendments after they have operated for 4 years and 6 months and that review is to be given to the Minister within 6 months and be tabled in each House of Parliament within 15 sitting days of its receipt by the Minister (**proposed section 54-75**).

Amendments to the *Life Insurance Act 1995*

Item 2 of Schedule 1 of the Bill will insert a **new Division 2A** into Part 10 of this Act. The new Division will provide that:

- an annuity will not be able to be assigned except to a revisionary beneficiary in accordance with the Bill (**proposed section 203C**), and
- a lump sum payment under the Bill cannot be assigned, commuted or otherwise cashed-out (**proposed section 203D**).

Application: The amendments will apply to settlements made on or after 26 September 2001 (**Part 3 of Schedule 1** of the Bill).

Concluding Comments

While the initial arguments put forward in of favour structured settlements focused on the tax exempt status of the initial lump sum compensation compared to the taxation of the income of an annuity purchased as part of a structured settlement, the resulting tax exemption of annuity income has resulted in a further tax inequality. As noted above, while the income from an annuity will be tax exempt, that from the investment of a lump sum will still be taxed. If the desire of the tax system is to be neutral between the treatment of various sorts of compensation payments, the income earned from the investment of a lump sum received as part of a personal injury compensation/damages payment should also be exempt. The policy expressed through the Bill is to encourage structured settlements over lump sum payments even though the recipient of the damages may prefer to make their own investment decisions if they receive a lump sum.

Endnotes

1 Department of Health, Review of Professional Indemnity Arrangements for Health Care Professionals, November 1995, recommendation 105.

2 The Structured Settlement Group, *Structured Settlements*, June 1999, p. 15.

3 Motor Accident Authority, *Structured Settlements*, 1998, p. 61.

4 Jane Ferguson, *Structured Settlements*, The Sydney Papers, Autumn 2001. (Jane Ferguson (Campbell) is a leading proponent of structured settlements.)

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5 The Age, 13 May 2000.

6 Assistant Treasurer, *Press Release*, 26 September 2001.

7 A brief history of the area is:

Without attempting to cover the full area of the reasons for increased medical insurance premiums and the difficulties facing the industry, it can be strongly argued that many of the difficulties arise from the difficulties experienced by United Medical Protection (UMP).

UMP (the actual insurance business was conducted by a wholly-owned subsidiary of UMP, Australian Medical Insurance Ltd - AMIL). UMP reportedly covered approximately 60% of Australia's doctors with about a coverage of 90% in Queensland and NSW. The history of UMP reveals that:

- It was formed in 1997, largely from the NSW Medical Defence Union
- It made a financial call on members in 2000, reportedly of $75 million[7]
- In 2001 it discloses $455 million in 'incurred but not reported' claims and that it has lost approximately $50 million in the collapse of HIH Insurance
- On 27 February 2002 the Australian Prudential Regulation Authority (APRA) issued a Media Release announcing that it had directed AMIL to raise additional capital by 30 June 2002 to ensure that it met the minimum capital requirements under the *Insurance Act 1973*
- On 28 March 2002 the Ministers for Health and Aging and Revenue and Assistant Treasurer issued a Joint Statement that the government would provide a financial guarantee of up to $35 million to enable AMIL to meet the APRA requirements up to 30 June 2002; and
- On 31 May 2002 the Prime Minister announced that the financial and various other guarantees would be extended 31 December 2002 while longer term strategies were developed and implemented.

8 Minister for Revenue and Assistant Treasurer, *Press Release*, 27 March 2002.

9 ibid.

10 Minister for Revenue and the Assistant Treasurer, *Press Release*, 28 March 2002.

11 The Australian, 6 November 2001.

12 Structured Settlement Group, *Structured Settlements*, June 1999, p. 14. While not explicitly stated, presumably this is for the year of their study.

13 Motor Accident Authority, *Structured Settlements*, 1998, p. 48.

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