



## Structured settlements: *an overview of the new federal and state laws*

Structured settlement legislative amendments were included as part of the public liability reforms introduced by the Australian federal, state and territory governments in late 2002. In this article, Jane Campbell outlines these new rules and what they mean for personal injury lawyers and clients.

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### DEFINITIONS

The term 'structured settlement' is generally understood to mean a settlement agreement in a personal injury matter in which the defendant agrees to pay at least part of the compensation to the plaintiff in the form of periodic payments. The periodic payments are usually funded by the purchase of an annuity by the defendant or the defendant's insurer.

An 'annuity' can be generally understood to be a financial product, usually offered by a life insurance company, which provides a series of periodic payments in return for the single premium purchase price. An annuity is usually payable for the lifetime of the annuity owner, or for a fixed number of years.

As discussed below, the terms 'structured settlement' and 'personal

injury annuity' have been defined to have very specific and technical meanings under the new federal tax legislation.

### EXISTING STATE LAWS NOT USED

For many years, 'structured settlements' have been referenced in various pieces of state motor vehicle and workers' compensation legislation. For example, section 81 of the *Motor Accidents Act 1988* (NSW) and section 135C of the *Accident Compensation Act 1985* (VIC) both dealt with 'structured settlements' and enabled their use in certain circumstances.

Despite these sections, parties to personal injury cases have not entered into structured settlements. The primary reason for this has

always been the uncertain tax treatment of periodic payments derived from structured settlements. This uncertainty meant that there was no clear tax incentive for parties to use structured settlements.

## NEW FEDERAL TAX LAW

Now the federal tax law has been amended to state that the periodic payments derived from structured settlements are tax-exempt. The *Taxation Laws Amendment (Structured Settlements and Structured Orders) Act 2002* (Cth) which makes this change was passed through parliament on 13 December 2002 and given Royal Assent on 26 December 2002.

This legislation amended the *Income Tax Assessment Act 1997* (Cth) and also the *Life Insurance Act 1995* (Cth). It states that any structured settlement entered into after 26 September 2001 is tax-exempt. This new law is effective now. This means that if your client entered into a structured settlement that satisfied the legislative requirements today, the periodic payments would be tax-exempt.

## OVERVIEW OF THE NEW TAX RULES

The tax law has been amended to state that periodic payments derived from 'personal injury annuities' and 'personal injury lump sums' are tax-exempt when purchased under a 'structured settlement'.

A 'structured settlement' can now generally be defined under the new legislation to be a settlement agreement in a personal injury case in which a defendant or a defendant's insurer agrees to purchase at least one personal injury annuity for the plaintiff.

The rules require the purchase of a personal injury annuity that provides the 'minimum monthly level of support'. This annuity must:

- provide the plaintiff with monthly payments that start at a level at least equal to one-twelfth of the current annual age pension;
- continue for the life of the plaintiff;

and

- be indexed to the Consumer Price Interest.

This condition means that many cases will be too small to structure, as there will not be sufficient damages to enable the purchase of an annuity providing the minimum monthly level of support.

In reasonably large cases where this condition can be satisfied, a structured settlement can also involve the purchase of other tax-exempt personal injury annuities and 'personal injury lump sums'. The latter product involves a premium being paid in return for an agreement to provide one or more lump sum payments at an agreed future date/s if the plaintiff is still alive on the payment date/s.

## OBJECTIVES OF THE NEW TAX RULES

The aim of the new tax rules is to encourage plaintiffs to obtain financial advice before they settle their claims (because a structured settlement can only be arranged at the time of settlement, not afterwards). The rules also encourage plaintiffs to take at least part of their compensation in the form of a lifetime annuity that will provide at least a minimum level of regular guaranteed payments.

## NEW STATE LAWS

The structured settlement tax rules do not require court approval for structured settlements, but state and territory laws do require court approval for all settlements involving parties under a legal disability.

State and territory governments have responded to the new structured settlement tax law by amending their laws to confirm that judges do have the power to approve and make consent orders for structured settlements in those cases where court approval for settlements is required.

Given that most judges hearing personal injury matters don't have the power to make 'orders' for periodic payments, it was thought unclear whether or not they would have the

power to make 'consent orders' for periodic payments (structured settlements).

The new state and territory laws have sought to make it very clear that if the parties to a case agree to a structured settlement and then require court approval, the judge does have the power to make a consent order in the terms of a structured settlement.

For example, section 24 of the *Civil Liability Amendment (Personal Responsibility) Act 2002* (NSW) provides that 'a court may, on the application of the parties to a claim for personal injury damages, make an order approving of or in the terms of a structured settlement even though the payment of damages is not in the form of a lump sum award of damages'.

## STRUCTURED ORDERS

There was a very late amendment to the structured settlement tax Bill to extend it to cover 'structured orders'. This amendment was introduced by the government on its own initiative (it was not requested by any stakeholder group).

Structured orders are defined in the legislation to be essentially the same as structured settlements, but the important difference is that they are the result of a court order that has been imposed on the parties without their prior consent. Structured settlements require the consent of both parties, whereas structured orders do not require the consent of either party.

The tax legislation makes payments from personal injury annuities and personal injury lump sums that are purchased in the context of structured orders tax-exempt. It does not (and cannot) give judges the power to make structured orders.

Under existing state and territory legislation, judges do not have the power to impose judgments involving periodic payments (such as structured orders). If judges did have this power, then the structured orders that they made would result in tax-exempt payments, but at least at this point in time

judges do not have this power.

The federal government indicated that it extended the Bill to structured orders in order to make the tax amendment as wide as possible and to ensure that it would cover the situation in the future if and when states decide to give judges the power to make structured orders.

It is unlikely that state and territory governments will give judges this power at least in the short-to-medium term. In general, plaintiffs would prefer a choice as to whether they receive their compensation in the form of a lump sum or periodic payments, or some combination of the two. Defendants and their insurers also want choice. They would not want a structured order if it were more expensive than the alternative lump sum order or the negotiated settlement.

So the bottom line is that for the time being we can ignore structured orders because they are not possible.

## IMPACT OF FEDERAL AND STATE LAWS

The combination of the changes to federal tax law and state law mean that if a structured settlement can be agreed between the parties then:

- the periodic payments derived from the structured settlement will be tax-exempt; and
- if one of the parties to the structured settlement is under a legal disability, the settlement agreement can be approved by a judge and will retain its tax-exempt status.

## SPECIAL RULES IN NEW SOUTH WALES

Rather than simply enable structured settlements in cases involving those under a legal disability, the government used the *Civil Liability Amendment (Personal Responsibility) Act 2002* (NSW) to take things further in two main ways as discussed below.

### Lawyers

Section 25 imposes an express obligation on lawyers to advise a plaintiff in



writing about the availability of structured settlements and the desirability of financial advice. This obligation is now operative, but it raises a number of questions, including:

- does it apply to both defendant lawyers as well as plaintiff lawyers?
- are defendant lawyers allowed to write to plaintiffs in this way?
- which cases does it apply to? (Is it only cases that are large enough to structure?)
- are structured settlements 'available'?
- is it possible to get financial advice about structured settlements?

In relation to the last two questions, it should be noted that there are some issues adversely affecting the current availability of structured settlements and financial advice relating to them. These issues include the fact that financial products satisfying the tax rules are not yet available. The Department of Family and Community Services has not yet determined the treatment of these products, and the treatment of these products under the *Financial Services Reform Act/Corporations Law* has not yet been clarified by the Australian Securities and Investments Commission (ASIC).

These issues are all expected to be resolved over the next few weeks and months, but it does put an onus on personal injury lawyers to be up to date with the latest developments regarding the availability/possibility of offering a structured settlement.

### Judges

Section 23 provides that a court that decides to make an award of personal injury damages in respect of future loss exceeding \$100,000 must first notify all the parties to the proceedings of the terms of the award it proposes to make.

The court may then adjourn the case to give the parties an opportunity to agree to a structured settlement in light of this information.

The intention behind this section is to encourage judges to give parties one final chance to negotiate a structured settlement before it is too late (and a final lump sum judgment is made). It seems to be a sensible idea, but one practical issue worth noting is that the threshold seems too low. A sum of \$100,000 for future loss may or may not be enough money to have a structured settlement (depending on the plaintiff's life expectancy).

This rule means that if a structured settlement has not been agreed to by the time certain cases go to court, it is not too late. A case can go to trial and the judge can reserve his decision. When the judge is ready to give a decision (possibly many months later) there will still be an opportunity for the parties to agree to a structured settlement.

## CONCLUSION

The primary barrier to the use of structured settlements in Australia has always been their tax treatment. This barrier has been removed and a new tax incentive has been created with the passage late last year of federal tax legislation making structured settlements tax-exempt.

State and territory governments have responded quickly to this new law by passing complementary legislation that enables structured settlements even in cases where court approval for a settlement is required.

There will be a short delay before we see structured settlements happening in Australia while product providers develop suitable products and the Department of Family and Community Services and ASIC determine how they will treat these structured settlement financial products.

In the meantime, New South Wales lawyers are legally obliged to advise their clients about structured settlements and New South Wales judges are obliged to encourage their use. **PL**