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Guide to Structured settlements & Lump sum compensation payments



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Introduction

There are a number of issues you and your clients face when a compensation payment is received. These may include taxation, social security, investment and sometimes superannuation choices associated with receiving a compensation payment. Compensation payments can be lump sum or as a structured settlement. In either case, this guide is intended to provide you and your clients useful information to assist you in making informed decisions in these stressful times. After reading this guide, you should be able to:

- Understand the taxation treatment of structured and compensation payments
- Understand the Social Security implications of receiving compensation payments
- Understand how superannuation laws affect these payments
- Look at some of the common financial planning strategies to deal with the above issues

Whatever the case may be, Frontier Wealth Advisers can work with you and your clients to bring optimal solutions and strategies to your clients.

What is a compensation payment?

Broadly speaking, compensation payments are amounts paid to compensate a person for loss, wrong or injury suffered as a result of a breach of duty. The payment can be either a replacement of lost income or a compensation for an error such as breach of contract, personal injury or other compensable damage or injury.

The critical decision to receive payments as a lump sum or structured payments may have serious consequences. Our specialist advisers can work with you to consider all relevant issues when making such an important decision.

What is a structured settlement?

Structured Settlement is a reference to the way a claim for personal injury compensation is settled. These claims can arise in a number of ways including:

- Common law negligence claims for motor vehicle accidents
- Sporting accidents
- Public liability and product liability
- Medical indemnity

Structured settlements are not possible for workers' compensation type claims. In general, these settlements are an agreement between the parties to the personal injury and are structured such that the injured receives all or part of their compensation in the form of tax-exempt periodic payments called "annuities". You can only enter into a structured settlement if the lump sum compensation payment, awarded by the court is deemed to be a tax-free capital payment.

Taxation treatment of structured settlements and compensation payments

Lump sum compensation payments received in connection with injury or wrong are tax exempt (sec 118-37 ITAA97). New Div 54 of ITAA97 allows compensation payments to be structured as regular payments and these payments can be exempt from tax if the following conditions are met:

Taxations laws are very complex Frontier Wealth Advisers have the expertise to work with you and your clients, to navigate the tax issues to achieve an optimal solution for your clients.

- The claim is for compensation or damages in relation to injury suffered by a person.
- The claim is made by the injured person or their personal legal representative.
- The claim is based on the commission of a wrong, or right created by statute.
- The claim is not a worker's compensation type claim.
- The settlement is in the form of a written agreement between parties.
- The terms of the settlement require that all of the compensation or damages payment is to be used by the claimant or their insurer to purchase an income stream to be paid to the injured person or their trustee.

Introduction to social security

Centrelink uses two tests; the asset and income test, to establish if you are entitled to a benefit and the amount of benefit you are entitled to. The applicable test for a person is the test that results in the minimum payment. Both tests exempt certain amounts "the lower thresholds" and any amount over this threshold reduces pension entitlement until the "the upper threshold" is reached, above which no pension is paid. The principal home is exempt from the pension asset test with a few other assets. The thresholds as at 19 Sep 2012 are:

Table (1A) – Income test

| Marital status | Lower threshold (\$/fn) | Upper threshold (\$/fn) |
|--|-------------------------|-------------------------|
| Single Pensioner | 152 | 1,663 |
| Pensioner couple | 268 | 2,546 |
| Please note the maximum pension reduces by \$0.50 for every dollar of assessable income above the lower threshold (\$0.525 for each member of a couple). | | |

Table (1B) – Asset Test

| | Lower threshold (\$) | Upper threshold (\$) |
|---|----------------------|----------------------|
| Single Pensioner: Homeowner | 192,500 | 696,250 |
| Non-homeowner | 332,000 | 835,750 |
| Pensioner couple: Homeowner | 273,000 | 1,032,500 |
| Non-homeowner | 412,500 | 1,172,000 |
| The pension reduces by \$1.50 per f/n for every \$1,000 of assets above the lower threshold (single & couple). For allowances, entitlement is entirely forfeited if assessable assets exceed the lower threshold. | | |

Compensation payments and social security

Under social security laws, a compensation payment is money paid “wholly or partly in respect of lost earnings or lost capacity to earn” because of personal injury. It includes periodic or lump sum compensation. A payment which does not include an amount for loss of earnings or lost earning capacity is not compensation, examples of such payments include:

- victims compensation
- income protection payments by a superannuation fund

Frontier Wealth Advisers are experts in social security. We can work with your clients to maximise your client's benefits

However, the only impact of an exclusion from the compensation definition is that the amount is not subject to a lump sum pre-clusion period.

Lump sum compensation payments are assessable under the asset test. If your payment is within the asset test threshold, you still might not get a pension for a significantly long time because Centrelink applies a pre-clusion period to compensation payments. This is the period of time you have to wait before you get a benefit from Centrelink and is calculated as follows:

Compensation portion

Weekly income cut-off for single pensioners

The compensation portion is:

- the amount specified for loss of earnings and lost earning capacity, if compensation awarded by a court or tribunal.
- 50% of the total lump sum regardless of what the parties have agreed for loss of earnings or lost earning capacity, in a settlement.
- 50% if the “50% rule” is applied, it is applied to the total lump sum (eg includes legal costs if agreed as part of the settlement), excl amounts to be used to repay periodic compensation

If you have been in receipt of weekly compensation payments, the preclusion period will commence the day after those weekly compensation payments cease. If you have not received weekly compensation payments, the preclusion period will start on the day the loss of earnings or lost capacity to earn began.

Compensation payments and superannuation law

Superannuation is an attractive tax structure for your clients to invest their compensation payments because if certain rules are met, ***they can invest proceeds and have all interest and capital gains exempt from tax***. However, there are limits to amounts that can be contributed into superannuation. For the 2012-2013 financial year, these limits are:

- post tax “non concessional contributions”: \$150,000 or \$450,000 over 3 financial years.
- Pre tax: \$25,000 (including employer contributions).

Penalty taxes apply if a person is in breach of the above contribution rules. However, superannuation contributions, made from the proceeds of certain payments for personal injury can be excluded from the non-concessional contributions cap when certain conditions are met. There is no limit on the amount of contributions that can be made under the personal injury exemption. These rules are set out in section 292-95 ITAA 97 and are complex. Simply put, the contributions will be allowed if the payment is of a certain type, you obtain evidence that you are permanently disabled from two medical practitioners and make the contribution before the expiry of the set administrative period. We recommend that you engage our Specialist Advisers the moment a claim for personal injury is envisaged so that we can work with you and your client as well as the client’s doctor to navigate these complex rules and maximise benefits for your clients.

Case Study

Michelle Hills, aged 30, received a compensation payment of \$1,800,000. She had previously inherited her parent’s home and does not need a new home. Her income needs for living expenses, medical bills and ongoing home care for 3 days a week is \$100,000 net after tax.

As she may never be able to work again, Michelle wants to invest her money in capital secured assets to preserve her capital.

The implications of the compensation payment are:

| | |
|-----------------|--|
| Social security | A preclusion period of up to 20 years is imposed for social security purposes. So Michelle does not get income support until age 50. |
| Taxation | Assuming interest rate of 5%, income is \$90,000 and income tax payable is \$23,000 a year. |

What did we do?

Frontier Wealth Advisers worked together with Michelle's lawyers and applied the personal injury provisions of superannuation laws and adopted the following steps to help Michelle:

- Steps 1 – Involve her doctors to get medical opinion about the likelihood of Michelle ever going to work again. If she was permanently disabled, she could contribute the entire amount into superannuation.
- Step 2 – Manage this process to ensure medical opinion is obtained sooner to allow Michelle to contribute within the required time frame.

It became very evident when speaking to Michelle and her father that they wanted control over how the money will be invested and managed.

Our advice

We helped Michelle set up a Self Managed Superannuation Fund (SMSF) with a corporate trustee structure. We succeeded in getting the medical opinion in favour of Michelle and the entire payment was contributed to the SMSF and used to commence a tax free pension for Michelle. As capital security was important to Michelle, we helped her invest her super in a mix of direct bank deposits and corporate bonds paying high levels of interest income with a low risk profile. The combination of term deposits and corporate bonds provided an average interest rate of 6.50%. Michelle's situation pre and post advice is summarised below:

| | Without Advice (\$) | With advice (\$) |
|----------------------|---------------------|--|
| Estimated interest | 90,000 (5%) | 117,000 (6.5%) |
| Tax | 23,000 | 0.00 |
| Net Income | 67,000 | 117,000 |
| Required Income | 100,000 | 100,000 |
| (Deficit)/Surplus | (33,000) | 17,000 |
| Drawdowns on capital | (33,000) | Nil; surplus of \$17,000 pa reinvested |

Our core compensation advice services

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| At Frontier Wealth Advisers, we can help to: | |
| • Explain how social security and superannuation laws will affect claimants | ✓ |
| • Work with clients, their legal adviser and doctors to obtain medical opinion regarding disability; we can explain both the purpose and the rules to doctors. | ✓ |
| • Provide advice on the most suitable investment / ownership structure to use | ✓ |
| • Provide advice on the most suitable investments for the client | ✓ |
| • Provide advice on tax effective ways of investing the lump sum capital | ✓ |
| • Take the stress out of the whole process by working with all parties to ensure all entitlements are maximised, where possible | ✓ |
| • Help in deciding between lump and structured payments since each have different implications for social security, tax and managing longevity risk | ✓ |