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A financial planning perspective on structured settlements

To achieve our goals requires preparation. There is information to be gathered and considered, a preliminary plan to be formulated, any necessary fine-tuning to be done, and then the implementation to achieve the final outcome. Financial planning for individuals who receive compensation is no exception.

The advent of structured settlements makes the financial process particularly essential. It also makes it necessary to move financial planning forward so that initial consultations take place before the settlement process. People often seek financial advice with cheque in hand or on the way. It is our experience that the average compensation recipient has done very little to prepare themselves for a financial planning consultation, and this will have serious repercussions for those considering taking a structured settlement option.

Clients are also often primarily concerned with the investments they intend to make. Little or no consideration is given to the ability of these investments to deliver on their long-term objectives. The information they have may be an *ad hoc* conglomeration of well-intended advice from family and friends that often does not meet their needs.

Until now, the nature of the compensation process has been to focus the client on a lump sum. However, as planners, we have been refocussing clients for years on the unbundling of that lump sum into different parcels to meet their key needs such as long-term lifestyle costs and capital expenditure.

Redirecting the attention of a client on his or her real needs and exploring the appropriateness of a structured settlement will bring forward consideration of the key issues. The decision whether or not to opt for a structured settlement may then be made with a full understanding of all of the issues and alternatives.

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This article revisits a series of case studies recently presented at APLA's Queensland Conference 2003 and looks back at how advice in these client situations may have varied had structured settlements been available at the time.

1. TOO MANY COOKS

John was literally surrounded by advice. He was a chef who left the military on account of a non-functional leg caused through the negligent treatment of a football injury. He had a compensation payment of approximately $500,000 to manage.

His family was keen to go into business with him and he had a friend who had shady connections, although these connections were not known at the time.

John initially wanted to develop a quality financial plan. However, this never eventuated. Instead, John entered into an unsuccessful business venture. He also chased a quick return by placing a loan to a Gold Coast business through a friend. This debt became bad.

A few months later, his own business was not travelling well, and he had to deal with the police in relation to the recovery of his loaned funds. Soon after his settlement, 80 per cent of it had been lost. This was a disastrous outcome.

The Appropriateness of a Structured Settlement

Had a structured settlement been available for John and had he accepted it, such capital losses may have been prevented. Apart from providing tax effective income streams, the essential aim of structured settlements is to protect hard earned compensation payments from early dissipation.

In John's case, too many cooks spoilt his broth. Furthermore, his mindset was cast in stone even at the time when he was apparently enthusiastically involving himself in a financial planning process.

2. SONG AND DANCE

Jane, aged 25, received a compensation payment of around $150,000. She now had the funds to pursue her dream of studying music and dance, although this meant deferring her business studies.

To do this, Jane needed to relocate from Brisbane to Sydney for three years. Working on her financial plan, it was agreed that she required around $15,000 per annum to meet her costs of living in Sydney, including rent and supporting herself through three years of study.

A well-intended relative suggested that she invest in a home unit in Brisbane. From a planning perspective, it is important to match investments with the goals the money is to fund. Whilst raising no objection to the idea of an investment property, it was pointed out that the rental income from a Brisbane property would not even cover Jane's Sydney rent, let alone her lifestyle costs.

The advice given was that Jane establish a broadly diversified investment portfolio. Jane would need to draw on 10 per cent of her portfolio for each of the three years that she would be living in Sydney. Projections demonstrated that when she earns an income after completing her business studies she would no longer need to draw on her portfolio to the same extent and that it would grow for her future from this time.

The Appropriateness of a Structured Settlement

In Jane's case a structured settlement would not have been appropriate. First and foremost, she had insufficient capital to purchase an annuity capable of delivering the required pension equivalent due to her life expectancy. Further, given her relative youth and potential earning capacity, greater flexibility in her planning was required.

3. A CHANGE OF PLANS

Bob, aged 30, sustained a leg injury and could not return to his employment as a plumber.

He received compensation of approximately $500,000. However, as he owned his own home outright and had a long-term income stream from income protection, he had no need to derive an income from his compensation monies.

He had already sought financial advice and had his compensation payment placed in a portfolio of managed funds. The overall effect of this investment strategy was to increase his taxation liability over and above that for the income protection by $6,000.

Through the superannuation system, John was able to unwind his earlier investment portfolio and contribute the proceeds to superannuation. With assistance, he obtained doctors' certificates that satisfied the 'Permanent Incapacity Condition of Release' which enabled him to convert his portfolio to an allocated pension even though he is only 30 years of age.

The overall effect of this strategy was to provide John with a tax-free investment portfolio and tax-free income. As he did not need the income from his allocated pension he subsequently made tax deductible superannuation contributions and reduced the tax on his income protection to zero. Quality advice resulted in John holding essentially the same portfolio through a different structure and saving around $9,000 in taxation per year.

The Appropriateness of a Structured Settlement

Given the size of John's funds, he was an ideal candidate for a structured settlement. This may have been particularly so if he had not been in receipt of his income protection. This case study demonstrates the value of advice over and above simply determining where money should be invested. It also demonstrates that good taxation outcomes can be obtained outside the structured settlement regime. Where this is the case, the issue will largely be whether or not a client should have investments that they control and consequential investment risk, versus the long-term certainty of an indexed income stream coming from a life assurance company.

SO WHO WILL STRUCTURED SETTLEMENTS SUIT?

The situation of each client situation requires case-by-case analysis. There is more to deciding upon the appropriateness of a structured settlement than simply taxation, financial calculations and investment projections. It ultimately comes down to how people feel about things.

Experienced financial planners are used to explaining and considering the pros and cons of annuities versus the investment of lump sums. What is new about structured settlements is the availability of annuities on a tax-free basis for the compensation recipient. What is not new is the annuity itself.

For many years now, similar decisions regarding annuities versus the control of capital have manifested themselves in the general population. For example, those in public sector superannuation schemes have choices between indexed pensions and lump sums. Other examples come up in age pension planning and superannuation.

In fact, there are many issues in common that apply in choosing between an annuity and a lump sum in which planners have experience. These issues include:

- the client's attitude to control of capital;
- the likelihood of the need to access capital for contingencies;
- the client's attitude and willingness to take investment risks;
- the client's overall level of financial sophistication and the likelihood that they may stick with a long-term investment strategy;
- the client's ability to earn an income and not be dependent on a long-term income stream; and
- other factors unique to that client's situation (for example, when dealing with a younger client who has been catastrophically injured, it may be necessary to take into account parental concern regarding the longevity of capital and their own ability to provide care in the future).

THE IMPACT ON THE PLANNING TIMELINE

In the pre-structured settlements regime, it was possible to leave financial planning to the settlement or beyond because the time frame for making investment decisions was uncapped. With structured settlements, however, it is imperative that all relevant issues are considered well in advance of settlement so that clients may make informed decisions in their long-term interest. PL