TR 2002/D13 - Income tax: assessability of statutory personal injury compensation scheme payments

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Draft Taxation Ruling

Income tax: Assessability of statutory personal injury compensation scheme payments

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Preamble

Draft Taxation Rulings (DTRs) represent the preliminary, though considered, views of the Australian Taxation Office. DTRs may not be relied on by taxation officers, taxpayers and practitioners. It is only final Taxation Rulings that represent authoritative statements by the Australian Taxation Office of its stance on the particular matters covered in the Ruling.

What this Ruling is about

Class of person/arrangement

1. This Ruling sets out the income tax implications under the *Income Tax Assessment Act 1997* ('ITAA 1997) for a taxpayer in respect of amounts received under a statutory personal injury compensation scheme other than amounts that are specifically exempt from income tax under the Act.

2. The *Taxation Laws Amendment (Structured Settlements and Structured Orders) Bill 2002* has been passed by Parliament and is awaiting Royal Assent. The Bill provides an income tax exemption for annuities and certain deferred lump sums paid under structured settlements to seriously injured persons. The measure is intended to encourage the use of structured settlements for personal injury compensation. Payments from 26 September 2001 that qualify for this tax exemption are not the subject of this Ruling.

Ruling

3. Whether statutory personal injury compensation scheme payments are assessable depends upon the nature of the payment in the hands of the recipient. The table below provides guidance as to the assessability of such payments:

Nature of payment	**Periodical payment**	**Lump sum payment**	**Instalment payment**	**Commuted payment**
Payment to compensate for loss of income	assessable	assessable	assessable	assessable

Payment to compensate for loss of capital	assessable[1]	non-assessable	non-assessable	non-assessable
Re-imbursement	non-assessable	non-assessable	n/a	n/a
Advance	non-assessable	non-assessable	n/a	n/a

4. A payment received under a statutory personal injury compensation scheme will be assessable when paid as compensation for loss of income, irrespective of the way the payment is made. In most cases it will be apparent from the relevant statute whether an amount is paid to replace income that has been lost as a result of a personal injury. Relevant factors will include where the statute bases the payment on:

- the person's earnings just prior to the injury;
- average weekly earnings within the particular statutory jurisdiction;
- earnings as per the relevant award; or
- the difference between pre-injury earnings and compensation payments.

5. As the table at paragraph 3 shows, in most instances a payment received under a statutory personal injury compensation scheme will be non-assessable when paid as compensation for loss of capital. An exception to this is when a payment is made periodically, but not as an instalment or interim payment of an ascertained capital lump sum. One or more of the following characteristics will combine with periodicity to give the amount its income nature:

(i) it is made in substitution of income;

(ii) it is made to provide financial support, for example, as an income supplement; or

(iii) it is received in circumstances where the recipient has an expectation of receiving the payment and the recipient is able to rely on the payment for his or her regular expenditure.

Definitions

6. The following definitions are used in this Ruling:

[1] Except where it is an annuity payment that is made periodically but not as an instalment or interim payment of an ascertained capital lump sum.

advance – an amount paid in advance of an expense to meet specified expenditure. Any unspent amount must be repaid.

annuity – a periodic **amount** (whether fixed or variable) which may be for a fixed term or for life and either purchased or not purchased.

assessable receipt – an amount that is assessable income under section 6-5 or 15-30 of the ITAA 1997, or would be assessable income if not for a specific exemption such as the Veterans' Affairs disability pension which is exempt under section 6-20 of the ITAA 1997.

commuted payment – a periodic receipt that is commuted or redeemed as a lump sum.

non-assessable receipt – a capital receipt that is disregarded under section 118-37 of the ITAA 1997.

periodic or periodical payment/receipt –a receipt that is one of a series of payments, or would usually be one of a series of payments. Examples include weekly workers' compensation, a single workers' compensation receipt and a lump sum arrears of workers' compensation.

re-imbursement – an amount paid to meet specified expenditures already incurred as a result of the injury.

statutory personal injury compensation scheme – any legislation of the Commonwealth, State or Territory regarding the payment of damages for personal injury compensation.

structured settlement – a method of paying personal injury damages by instalments. It may be in the form of an annuity, by way of an advance or as instalments of capital. The term structured settlement as used in this Ruling does not include those payments that from 26 September 2001 will meet the requirements for tax exemption in accordance with the new legislation.

Date of effect

7. When the final Ruling is offically released, the final Ruling will have the following date of effect. Please see the preamble in this Draft Ruling. This Ruling may impact on decisions previously given in relation to a number of compensation schemes. To the extent that the Ruling is unfavourable to taxpayers, the Ruling applies to amounts paid from the date of issue of the final Ruling. There is a prospective date of effect for this Ruling because the ATO has previously issued private Rulings which contain the view that commuted lump sum

payments are not assessable income. To the extent that this Ruling is favourable to taxpayers, it applies to amounts paid both before and after its date of issue. For example, the latter may occur where amounts were calculated under subsection 137(4) of the *Safety, Rehabilitation and Compensation Act 1988* as was the case with the post age 65 component considered in *Coward v. FC of T*.[2] The normal four year amendment period in section 170 of the *Income Tax Assessment Act 1936* (ITAA 1936) applies.

8. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Previous Rulings

9. Taxation Ruling IT 2193 and Taxation Determination TD 93/3 will be withdrawn from the date of issue of the final Ruling.

Related Rulings

10. Taxation Ruling TR 2002/D12: Income tax: eligible termination payments (ETP): payments made in consequence of the termination of any employment: meaning of the words 'in consequence of'.

Background

11. The Explanations section is divided into the following parts:

- Position of statutory personal injury compensation schemes in the general framework of personal injury compensation;
- What is 'income'?;
- What is an 'instalment of capital'? This explains the distinction between the columns in the table at paragraph 3 which deal with payments that are made periodically ('Periodical payment') and payment of an ascertainable lump sum by instalments ('Instalment payment'). This distinction is relevant in determining the correct tax position for periodic payments which are to compensate for loss of capital.

[2] *Coward v. FC of T* 99 ATC 2166; AAT Case [1999] AATA 132 41 ATR 1138.

Explanations

Position of statutory personal injury compensation schemes in the general framework of personal injury compensation

12. Statutory personal injury schemes emerged as a consequence of problems with the common law including:

- the difficulty of proving negligence. This resulted in some statutory schemes being 'no-fault' schemes;
- the cost of the legal process;
- the delay in getting damages;
- difficulties in determining an appropriate lump sum. This resulted in the design of an 'advance' form of structured settlement; and
- poor management of the lump sum. This resulted in many schemes providing for periodical payments.

13. Payments made under a statutory personal injury compensation scheme may have a different tax treatment to those made under the common law. As a general rule, a common law personal injury receipt is a non-assessable undissected lump sum.

What is 'income'?

14. Under subsection 6-5(1) of the ITAA 1997 an amount is assessable income if it is income according to ordinary concepts ('ordinary income').

15. Some of the tests developed by the courts when determining whether an amount is ordinary income are:

- the character of the amount in the hands of the recipient;[3]
- whether upon a close examination of all relevant circumstances it can be concluded that the payment received is income;[4]
- the application of an objective test;[5] and

[3] *FC of T v. Blake* 84 ATC 4661; (1984) 15 ATR 1006 - refer comments of Carter J at ATC 4664; ATR 1010; *Scott v. FC of T* (1966) 117 CLR 514, at 526; (1966) 14 ATD 286, at 293; *GP International Pipecoaters Pty Ltd v. FC of T* (1990) 170 CLR 124, at 136; 90 ATC 4413, at 4419; (1990) 21 ATR 1, at 6.
[4] *The Squatting Investment Co. Ltd v. FC of T* (1953) 86 CLR 570, at 627; (1953) 10 ATD 126, at 146.
[5] *Hayes v. FC of T* (1956) 96 CLR 47, at 55; (1956) 11 ATD 68, at 73.

- reliance on the ordinary concepts and usages of mankind (except where a statute dictates otherwise).[6]

16. Specific tests that are used to determine whether an amount is ordinary income include:

- whether the amount is the product of any employment, services rendered, or any business;[7]
- the form of the amount; that is, whether it is received as a lump sum or periodically;[8]
- whether the amount is paid in substitution for another amount so as to take on the character of the substituted amount;[9]
- whether there is an expectation of receipt of the amount on a regular basis so that the recipient is able to depend upon the amount for his or her regular expenditure;[10] and
- the motive or purpose of the person paying the amount. Motive, however, is rarely decisive, as in many cases a mixture of motives may exist.[11]

17. For further explanation and discussion on what is income according to ordinary concepts see Taxation Ruling TR 1999/17.

Drawing together the authorities on the general principles of income – *Coward v. FC of T*

18. In *Coward*, Mathews J, sitting as President of the Administrative Appeals Tribunal, reviewed a number of Full Federal Court cases on the assessability of statutory compensation payments for personal injury, that is *Tinkler v. FC of T,*[12] *FC of T v. Slaven*[13] and

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[6] *Scott v. Comr of Taxation (NSW)* (1935) 35 SR (NSW) 215; (1935) 3 ATD 142 per Jordan CJ at SR 219; ATD 144.
[7] *FC of T v. Harris* (1980) 43 FLR 36; 80 ATC 4238; (1980) 10 ATR 869, at FLR 40; ATC 4241; ATR 872; *Hayes v. FC of T* (1956) 96 CLR 47, at 54; (1956) 11 ATD 68, at 72.
[8] *FC of T v. Dixon* (1952) 86 CLR 540, at 557; (1952) 10 ATD 82 , at 86.
[9] *FC of T v. Dixon* (1952) 86 CLR 540; (1952) 10 ATD 82, *FC of T v. Inkster* 89 ATC 5142; (1989) 20 ATR 1516, *Moneymen Pty Ltd v. FC of T* 91 ATC 4019; (1991) 21 ATR 1142, *FC of T v. D.P. Smith* (1981) 147 CLR 578; 81 ATC 4114; 11 ATR 538, *FC of T v. The Myer Emporium Limited* (1987) 163 CLR 199; 87 ATC 4363; (1987) 18 ATR 693.
[10] *FC of T v. Dixon* (1952) 86 CLR 540; (1952) 10 ATD 82.
[11] *Hayes v. FC of T* (1956) 96 CLR 47, at 55; (1956) 11 ATD 68, at 72-73.
[12] *Tinkler v. FC of T* 79 ATC 4641; (1979) 10 ATR 411.
[13] *FC of T v. Slaven* (1984) 1 FCR 11; 84 ATC 4077; (1984) 15 ATR 242.

FC of T v. Inkster.[14] In analysing those authorities, Mathews J sought to draw some key distinctions.

19. In *Coward*, three sets of payments were received by the taxpayer which required examination, namely, the periodic payments which the taxpayer received until he turned 65, the periodic payments which he was entitled to receive thereafter, and the lump sum redemption payment. Although it was the status of the redemption payment that was at issue, Mathews J was of the view that the status of this payment could not be considered in isolation from the status of the earlier weekly payments to which the taxpayer was entitled.

20. Mathews J concluded that, on the basis of the wording of the relevant legislation, the weekly payments made to the taxpayer before he turned 65 were by way of compensation for loss of earnings and as such, clearly constituted income in his hands.

21. The weekly payments that the taxpayer was entitled to receive after he turned 65 also constituted income in his hands because the periodic nature of the payments and the fact that they served as an income supplement meant that they continued to have the character of income. This was so notwithstanding that they were designed to compensate him for loss of earning capacity. Mathews J cited the judgment of Lee J in *Inkster* in support of this analysis. In this regard, Mathews J said:

> 'The fact that there is a statutory reduction in the rate of weekly compensation payments when the recipient turns 65 plainly recognises that most members of the community are no longer in the workforce at that age. The object of compensation which then becomes payable can no longer be to compensate the individual for lost earnings, for it is assumed at that stage that there would not in any event be any earnings. What, then, was the nature of the payments to which the applicant was entitled after he turned 65? The answer provided by the majority in *Inkster*, in not dissimilar circumstances, is that the payments represented compensation for loss of earning capacity. As such, the payments had their genesis in capital, but nevertheless were income in the hands of the applicant so long as they were paid on a weekly basis.'[15]

22. In summarising his understanding of what Mathews J was saying in *Coward* on this issue, Senior Member Block said in a later case (ATC at 2461; ATR at 1240):

> '…..where an applicant is entitled to a weekly compensation payment, and he then, as a matter of right, redeems that amount in accordance with a formula calculation which is related to the weekly payment and the period during which it is likely to be paid, the lump

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[14] *FC of T v. Inkster* 89 ATC 5142; (1989) 20 ATR 1516.
[15] *Coward v. FC of T* 99 ATC 2166, at 2180; *AAT Case* [1999] AATA 132 41 ATR 1138, at 1154.

> sum payment is likely to be a substitute for income and thus stamped with the character of income.'[16]

23. The weekly compensation payments that the taxpayer was entitled to receive after he turned 65 formed the basis of the calculation of the lump sum redemption payment. Those weekly payments could no longer be regarded as a substitute for lost income as Mathews J considered them to be compensation for the loss of earning capacity.

24. Once the weekly payments were converted into a lump sum redemption amount, the principal feature of periodicity which had given the weekly amounts, paid after the taxpayer had turned 65, the character of income was clearly lacking and hence the lump sum was capital and not assessable.

25. In considering the three sets of payments in *Coward*, Mathews J examined both *Tinkler* and *Slaven* before considering *Inkster*. In *Tinkler*, the Full Federal Court considered the assessability of periodic receipts paid under a statutory motor accident scheme for 'loss of income in the capacity of employee'. The court held that the receipt was a 'statutory substitute, *pro tanto*, for the salary or wages lost'[17] and therefore income. The decision was based on the purpose of the statute which was to provide a partial recoupment of lost income, and the periodic nature of the receipts.

26. Following the decision in *Tinkler*, the statute was amended to remove the explicit reference to 'loss of income' so that the payment became one which was to compensate for the 'deprivation or impairment of earning capacity'. The impact of the amendments was considered by the Full Federal Court in *Slaven* where it was noted that the intent of the Victorian Parliament in amending the statute was to achieve a non-taxable compensation receipt:

> 'We have read the second reading speeches of the relevant Ministers before the Legislative Assembly and the Legislative Council of Victoria in relation to the Motor Accidents Amendment Bill 1979 from which it is plain beyond argument that the principal problem which the 1979 Act was intended to overcome was the attraction of income tax to benefits paid under the Act.'[18]

27. In *Slaven*, the compensation paid to the taxpayer was expressed to be for deprivation or impairment of earning capacity and was calculated having regard to loss of earnings already incurred, likely loss of future earnings and other relevant matters such as the nature of the injury. The compensation was paid to the taxpayer in

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[16] *Barnett v. FC of T* 99 ATC 2444; *AAT Case* [1999] AATA 950 43 ATR 1221.
[17] *Tinkler v. FC of T* 79 ATC 4641, at 4642 and 4645; (1979) 10 ATR 411, at 413 and 416.
[18] *FC of T v. Slaven* (1984) 1 FCR 11; 84 ATC 4077 at 4084; (1984) 15 ATR 242 at 251.

five irregular instalments which fairly closely approximated her net pre-accident earnings. The Full Federal Court held that the irregular payments under the amended statute were capital in nature and were instalments of an ascertainable lump sum for the loss of earning capacity - see paragraphs 40 to 44 of this Ruling.

28. In *Inkster*, the taxpayer, having retired, was living on a superannuation pension at the time that the compensation was awarded and had ceased earning income from employment. The weekly compensation payments were calculated by reference to wages paid to employees in his former workplace. No loss of income had been established or was sought to be established. Thus, even though the compensation was awarded for a disability inflicted in the course of the taxpayer's employment, it did not in fact replace income because no income was lost.

29. Nevertheless, the Full Federal Court held that the receipts were income. Pincus J found that the 'essential character and purpose' of the compensation statute was to replace income and used this to determine that the payments were income. Lee and Gummow JJ reached the same conclusion by combining the factors of regularity and recurrence with the relationship between the calculation of the payments and notional earnings and with the purpose of the payments which was to provide a regular supplement to whatever income the taxpayer received.

30. In considering whether the compensation payments, calculated as weekly payments and paid regularly, took on the character of income by virtue of their periodicity, Lee J noted that the payments were not in the nature of payments by way of instalments of a fixed sum. He also noted that the payments were intended to serve the purpose of providing a regular income supplement, notwithstanding that the payments were generated by calculations which related to capital considerations. Lee J thought that the calculation of such payments by reference to, and as part of, weekly income and the regular receipt of the payments might be sufficient to attract the character of income. Periodicity of payment alone may not be determinative of whether the payments were income but such a circumstance was important and additional circumstances might make it clear that the payments did have that character. His Honour proceeded:

> 'If the respondent had been able to commute his entitlement, the sum received may have been a capital receipt as far as the respondent was concerned having regard to the particular circumstances of his case, but the receipt of regular periodical payments pursuant to the scheme for such payments provided by the Compensation Act was able to give what otherwise may have been a capital receipt the character of income. The circumstances and manner of payment may convert what would otherwise be capital payments into income. (See

Egerton-Warburton v. DCT (1934) 51 CLR 568 per Rich, Dixon and McTiernan JJ at 572-3.).'[19]

Regularity or periodicity of the receipt

31. Periodicity is a characteristic that is frequently identified by the courts as a key factor in determining whether an amount has the character of income according to ordinary concepts. Although income will usually have an element of periodicity, recurrence or regularity,[20] this element is not always essential for an amount to be income. A single receipt or the proceeds of an isolated transaction, even if received as a lump sum, may well be income.[21]

32. However, periodicity alone may not be determinative of whether amounts are income. A receipt may have the elements of periodicity, recurrence or regularity but nevertheless not be income. For example, instalments of a capital sum, even though received regularly from one source, are not income[22] - for further discussion see paragraphs 40 to 44 of this Ruling.

33. It can be seen from the judgments of Dixon CJ and Williams J in *FC of T v. Dixon*[23] that it was not only the periodicity of the receipt that was relevant in determining that the receipt was a receipt of income. Also relevant was the fact that the taxpayer depended on the receipt for his day to day living expenses. Moreover, in Fullagar J's judgment, the periodicity test was linked with a further test, the substitution test, meaning that a receipt paid in substitution for another takes the character of the substituted receipt.

34. Thus, while periodicity, recurrence and regularity are influential factors in concluding that a receipt is ordinary income, they are not determinative. However, these factors are usually present in an income receipt and often appear in conjunction with other features of ordinary income.

Substitution of income

35. In *Coward* the amount of compensation payable, as represented by the periodic payments received by the taxpayer until age 65, was directly referable to average weekly earnings before injury. Based on the reasoning of the Federal Court in *Tinkler v. FC*

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[19] *FC of T v. Inkster* 89 ATC 5142, at 5159 - 5160; (1989) 20 ATR 1516, at 1535.
[20] *FC of T v. Dixon* (1952) 86 CLR 540; (1952) 10 ATD 82, *FC of T v. Blake* 84 ATC 4661; (1984) 15 ATR 1006.
[21] *FC of T v. The Myer Emporium Limited* (1987) 163 CLR 199; 87 ATC 4363; (1987) 18 ATR 693.
[22] *FC of T v. Slaven* 84 ATC 4077, at 4085; (1984) 15 ATR 242, at 252 – 253.
[23] *FC of T v. Dixon* (1952) 86 CLR 540; (1952) 10 ATD 82.

of T,[24] Mathews J found in *Coward* that the compensation payments were income as they were in substitution for the income that the taxpayer would have earned if it were not for the injury. See also *Commissioner of Taxes (Victoria) v. Phillips.*[25]

Provision of financial support

36. In *Coward*, the periodic payments that the taxpayer was entitled to receive after he turned 65 were income as they were intended as an income supplement. This fact, together with their periodicity, made them income in the hands of the recipient notwithstanding that there was no loss of income to which the payments were directed as a substitute.

Reliance on receipt for regular expenditure

37. This is another factor that requires consideration. It is particularly relevant to pensions and social welfare benefits.[26]

38. In *Dixon* it was stated that where amounts are periodical or regular receipts to which the taxpayer looks to maintain himself and his dependants then they will be in the nature of income. Further, in applying the principles in *Dixon*, White J in *Keily v. FC of T* said that:

> 'In the case of an aged person's pension, the generally accepted characteristics of income (recurrence, regularity and periodicity) are present. In addition, the pensioner has a continuing expectation of receiving periodic payments, an expectation arising out of established government policy with respect to the support and welfare of aged citizens. Pension payments form part of the receipts upon which a pensioner depends for support. And a pension is paid to the pensioner for that purpose. A pensioner (sic), therefore, satisfies the criteria or characteristics of income discussed in *Dixon's* case.'[27]

Are lump sum compensation payments eligible termination payments (ETPs)?

39. In *Gillespie v. FC of T*[28] the AAT held that a commuted lump sum workers compensation payment was income but was taxable as an ETP. The AAT found that the lump sum payment was an ETP because it was made in consequence of the taxpayer's employment. The decision in *Gillespie* and the issue of when a payment is made in

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[24] *Tinkler v. FC of T* 79 ATC 4641; (1979) 10 ATR 411.
[25] *Commissioner of Taxes (Victoria) v. Phillips* (1936) 55 CLR 144.
[26] *FC of T v. Harris* (1980) 43 FLR 36; 80 ATC 4238; (1980) 10 ATR 869.
[27] *Keily v. FC of T* 83 ATC 4248, at 4249; (1983) 14 ATR 156, at 158.
[28] Case [2001] AATA 1009; 2002 ATC 2006.

consequence of the termination of employment is discussed in Taxation Ruling TR 2002/D12.

What is an 'instalment of capital'?

40. In some cases instalments or interim payments are made ahead of ascertainment of a lump sum for the loss of earning capacity where the lump sum cannot be determined with any degree of precision beforehand. Some personal injury compensation statutes provide for the non-economic loss component of a personal injury award, such as pain and suffering, loss of limbs, etc., to be paid by instalments.

41. In such cases, instalments of a fixed lump sum will not be assessable when paid for a definitive period and where the recipient, or their estate, has the right to the payment of the whole amount.

42. In *Slaven,* the Full Federal Court held that the personal injury statutory scheme under review allowed for interim payments to be made prior to ascertainment of the lump sum amount. It noted that (FCR at 21; ATC at 4085; ATR at 252):

> '…the scheme of the Act as amended, as we perceive it, is that before authorising any payments to applicants for compensation the Board must be satisfied that the person has suffered deprivation or impairment of his earning capacity, but it need not then determine the full amount of compensation payable. Indeed, the ascertainment of that amount may in some cases require extensive investigation of various matters including the nature of the injury, the past or future earning capacity of the person concerned and medical evidence relating to his injury. Although the Act as amended does not spell out in precise terms the relevant powers of the Board, in our view the Board may authorise the making of payments to persons pending the final assessment of the total amount of compensation whether they be described as interim payments or payments on account or as instalments.'

43. Where the particular statute requires the lump sum to be paid by instalments or by interim instalments pending ascertainment of the lump sum and the amount paid upon ascertainment of the lump sum is reduced by the instalments or interim payments, neither the instalments nor interim payments or the lump sum would be assessable ordinary income under section 6-5 of the ITAA 1997 or statutory income under section 6-10 of the ITAA 1997.

44. Irrespective of whether the compensation receipt is paid as a lump sum or by instalments, it retains its character as a capital receipt payable in respect of personal injury and hence the capital gain will be disregarded (section 118-37 of the ITAA 1997).

Alternative views

The statute under which the compensation is paid can determine the characteristic of the lump sum

45. It has been argued that the statute under which the compensation is paid can determine the characteristic of the lump sum receipt. Whilst '... the purpose of a statutory payment, as disclosed by the terms of the statute itself, must be a powerful, though not conclusive, aid to the determination of the character of the payment ...',[29] it is the taxation legislation, and not the statute, that determines whether a receipt is subject to tax. Compensation will not necessarily be assable merely because compensation for 'loss of earning capacity' is calculated on the basis of net earnings, rather than gross earnings.

46. Even if the statute under which the compensation is payable states that the lump sum is 'for loss of earning capacity', is 'a capital receipt' or 'is not subject to income tax', the amount may still be assessable. The factual circumstances of each payment must be considered in relation to the application of the taxation legislation.

Personal injury lump sums are not subject to tax

47. A further argument that has been advanced is that since a common law personal injury lump sum is not subject to tax, a statutory personal injury lump sum should not be subject to tax. This line of argument may well explain why many statutes indicate that a commutation is not subject to tax.

48. Common law personal injury compensation is currently required to be paid as a lump sum. It settles the matter once and for all and does not allow for reviews should the injured person's situation change in the future.

49. On the other hand, the statutory personal injury compensation schemes allow for the injured person, often without having to prove another's negligence, to receive compensation while the condition is assessed. Some schemes may treat the compensation received as an instalment of an amount that is ultimately to be calculated using common law principles once the condition stabilises- that is, the lump sum will still settle the matter once and for all. Some schemes have no regard to common law entitlements. Indeed, it is the high cost of calculating the common law amount that has resulted in the common law not being available under some statutory schemes.

50. Once a scheme has severed its connection with common law lump sums, it severs the connection with the tax consequences that

[29] *FC of T v. Slaven* (1984) 1 FCR 11; 84 ATC 4077, at 4085; (1984) 15 ATR 242, at 253.

attach to common law lump sums. Therefore, the commutation of a statutory income stream cannot become a common law lump sum.

Examples

Example 1: Periodic payments that are compensation for loss of earning capacity

51. Mavis was injured in a motor vehicle accident and has not been able to resume her job on a full-time basis. She usually only misses an hour or two of work each week. Under the statutory scheme, she is required to record the difference between her pre-injury gross and net (after tax) weekly income and post-injury gross and net weekly income and submit a claim for the shortfall when the difference between the net incomes reaches $500. The amount paid under the statute is the amount calculated as the difference between the net incomes. Although the statute states that Mavis is to be compensated for the 'loss of earning capacity', the amount is income because:

(a) the amount is paid pursuant to a statute law which requires the calculation to be made by reference to the loss of income;

(b) the amount paid can and will be relied upon to meet regular expenditure; and

(c) the amount paid is to act as a substitute for her regular income.

Example 2: Lump sum commuted payment that is compensation for loss of income

52. Jacob, an apprentice motor mechanic, was partially disabled riding his skateboard home from work. He lost the sight in one eye in a collision with an overhead branch of a tree. Under the terms of his employer's workers' compensation scheme he is entitled to weekly compensation until he turns 65. It has been estimated that he has a 10% disability and is entitled to $50 per week compensation. After two years Jacob became eligible for a redemption as the disability had stabilised. There is no specific formula in the legislation regarding his entitlement should he seek to redeem his weekly compensation. The insurer makes an offer of a lump sum in redemption of his weekly compensation entitlement. Should Jacob accept the offer, the lump sum redemption would be a commuted lump sum payment designed specifically to compensate for the loss of income and as such would be fully assessable as ordinary income in the year of receipt.

Example 3: Lump sum commuted payment that is compensation for loss of income

53. Henrietta, a kitchen hand, loses her index finger in the mincer. Her loss of earning capacity is estimated to be 20% or $85 per week. As the amount is less than $100 per week, the statute requires the compensation to be commuted using a formula which excludes the tax component because the legislation states that the payment is capital. The amount is for the period until Henrietta turns 65 and is discounted by 3%. Notwithstanding the terms of the legislation, the receipt is a commuted lump sum payment designed specifically to compensate for the loss of income and as such would be fully assessable as ordinary income in the year of receipt.

Example 4: Undissected lump sum

54. Bertha, a worker in a smelter, was injured when molten lead splashed onto her. She will need ongoing medical treatment. Bertha sued her employer for negligence. While awaiting the Court decision Bertha is entitled to weekly workers' compensation payments. The payments of weekly workers' compensation are assessable. Before the matter went to Court, Bertha and her employer agree to settle the matter. As a result Bertha receives an undissected lump sum which takes into account future medical expenses and income loss. As the lump sum is undissected, it is not assessable.

Example 5: Fixed lump sum to compensate for a loss of capital paid by instalments

55. Bill is entitled under a statute to a fixed lump sum personal injury amount to compensate him for a loss of capital. Instalments are payable with the instalments being fixed. A factor is applied to the lump sum so that it is revalued to allow for inflation over the period of the payments. The recalculated amount is then divided by the number of instalments to be made to determine the amount of each instalment. The statute provides for a lump sum of $7,500 to be paid annually over 4 years: $1,500 now and $1,500 for each of the next 4 years. The prescribed factor converts the sum of $7,500 to $8,000. The $8,000 is divided by the number of payments to be made to determine the annual payment resulting in 5 payments of $1,600 each. As the lump sum is an ascertainable capital amount the instalment payments are non-assessable.[30]

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[30] These payments will not meet the requirements of the new legislation regarding structured settlements to qualify for tax exemption. However, they are not assessable due to their capital nature.

Example 6: Unascertainable lump sum paid by CPI adjusted instalments

56. Mary is entitled under statute to a lump sum personal injury payment payable by instalments where the period is fixed and instalments are Consumer Price Index (CPI) adjusted. The lump sum is divided by the number of instalments to be made to determine the amount of each instalment. This amount is then adjusted to reflect movements in the CPI between the time that the lump sum was calculated and when the instalment is actually paid. The statute provides for a lump sum of $7,500 to be paid annually over 5 years: $1,500 now and $1,500 on each of the next 4 anniversaries. If the CPI adjustments were such that the next 4 payments amounted to $1,550, $1,580, $1,620 and $1,650 respectively, the total receipt would be $7,900. As the lump sum was not ascertainable and the instalments were increased due to CPI adjustments, the instalments are assessable as ordinary income as they are in the nature of annuity payments.[31]

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[31] These payments are not part covered by the new legislation relating to structured settlements. They remain assessable income.

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Your comments

58. We invite you to comment on this draft Taxation Ruling. We are allowing 9 weeks for comment before we finalise the Ruling. If you want your comments to be considered, please provide them to us within this period.

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Commissioner of Taxation
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Related Rulings/Determinations:
TR 92/20; TD 93/3; TR 2002/D12; IT 2193; TR 1999/17

Subject references:
- Compensation income
- Periodic receipts
- Personal injury
- Workers compensation income

Legislative references:
- ITAA 1997
- ITAA 1997 6-5
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- ITAA 1997 6-10
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- ITAA 1997 6-20
- ITAA 1997 15-30
- ITAA 1997 118-37
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- Safety Rehabilitation Compensation Act 1988 137(4)
- Taxation Laws Amendment (Structured Settlements and Structured Orders) Bill 2002

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- Case [2001] AATA 1009; 2002 ATC 2006
- Commissioner of Taxes (Victoria) v. Phillips (1936) 55 CLR 144;
- Coward v. FC of T 99 ATC 2166; AAT Case [1999] AATA 132 41 ATR 1138
- FC of T v. Blake 84 ATC 4661; (1984) 15 ATR 1006
- FC of T v. Dixon (1952) 86 CLR 540; 5 AITR 443; 10 ATD 82
- FC of T v. D.P. Smith (1981) 147 CLR 578; 81 ATC 4114; 11 ATR 538
- FC of T v. Harris 80 ATC 4238; 10 ATR 869
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- GP International Pipecoaters Pty Ltd v. FC of T (1990) 170 CLR 124; 90 ATC 4413; (1990) 21 ATR 1
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- Scott v. FC of T (1966) 117 CLR 514; 14 ATD 286
- The Squatting Investment Co Ltd v. FC of T (1953) 86 CLR 570; 10 ATD 126
- Tinkler v. FC of T 79 ATC 4641; (1979) 10 ATR 411

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