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EMPLOYEE BENEFITS – BETTER IN SUPER

Jeffrey Scott

In this time of fiscal responsibility, businesses need to weigh the costs and benefits of any expenditure. At the same time, employers want to retain good employees and accordingly, many employers are looking to provide life insurance benefits as incentives. When weighing up the cost and benefits, which option is better – should the insurance benefits be inside or outside of superannuation?

Background

The Choice of Fund requirements within the Superannuation Guarantee (Administration) Act stipulate that from 1 July 2008, employer nominated funds should offer the following minimum level of life insurance (death only):

Age range	Minimum level of term life insurance
Age	Sum insured
20–34	$50,000
35–39	$35,000
40–44	$20,000
45–49	$14,000
50–55	$7,000
55+	Nil

Alternatively, employer nominated funds may arrange insurance with a premium of at least $0.50 per week ($26 per annum) per employee under 56 years of age. This requirement ceases for those over the age of 56. If the employer nominated fund does not meet the above mentioned minimum insurance requirements, other insurance arrangements which meet these obligations may also be made by the employer.

Some employers who wanted to ensure that their employees were treated in an equitable manner, regardless of their superannuation arrangements, chose group insurance plans outside of superannuation. This ensured that all employees, whether they stayed in the employer nominated fund or not, received life insurance coverage. However, there are various implications associated with this, including fringe benefit tax (FBT) and benefit payments.

FBT on premiums

If an employer purchases a group insurance plan (outside of superannuation) which pays term, trauma, or total and permanent disability insurance benefits, then the entire insurance expense will be claimable as a tax deduction by the employer. The only problem is that if the employee has an 'absolute entitlement' to the benefits, the employer will be subject to fringe benefits tax (FBT) and additional FBT reporting obligations. Although FBT is a tax deduction to the employer, the total cost to the employer is almost doubled.

For example, if $1,000 in premiums is paid by the employer, FBT of $869 will apply making the total cost $1,869.

The FBT payable of $869 is derived as follows:
Value of benefit (premium) $1,000 x (FBT gross-up factor) 1.8692 x (FBT rate which is the same as the top marginal tax rate) 46.5%.

Also, if the employer allows the employees to purchase individual (retail) policies, and the employer pays the premiums referable to the term, trauma, or total and permanent disability cover, the insurance expense will also be tax deductible to the employer. But again, the employer will be subject to FBT. As in the above, the FBT is a tax deduction to the employer, but again the total cost to the employer is almost doubled.

Alternatively, if an employer makes a contribution to superannuation, which is then used to pay for insurance premiums, the entire contribution will be tax deductible to the employer and not subject to FBT. However, the contribution will count towards the employee's concessional contributions, which is subject to a cap of $25,000 per annum if the employee is under age 50 and $50,000 per annum if the employee is over age 50 for the 2011–2012 financial year. Any contributions exceeding these caps may give rise to additional tax liability payable by the employee (i.e. excess concessional contributions tax).

The superannuation fund in turn, can claim a tax deduction for the premiums referable to death cover (ss 295–460 and 295–465 ITAA 1997), total and permanent disability cover (any occupation after 1 July 2011. ATO TR 2011/D6; 295-465.01 ITA Regulations 1997), or income protection cover and may pass any benefits arising from this back to its members (TD 2007/3).

No FBT on premiums

What are the options available to employers?

It should be noted that in the case of an employer paying income protection insurance premiums on behalf of an employee outside of the superannuation environment, there will be no FBT on the premiums. This is due to the 'otherwise deductible' rule regarding fringe benefits (s37 & s52 FBTAA 1986). As an employee would have been entitled to a deduction for paying income protection premiums then an employer is entitled to the same deduction without incurring FBT (ss 8–1, 6–h5 ITAA1997; CR 2002/57).

Employers may wish to purchase a group insurance plan outside of superannuation (term, trauma, or TPD) of which they are both the legal and beneficial owners of the insurance policy. This insurance arrangement does not give rise to FBT liability or additional FBT reporting obligations because the employee has no rights under the policy. However, this means that the employee does not have certainty in receiving insurance benefits, as all payments are at the discretion of the employer.

Benefit payments

Prior to 1 July 2007, benefit payments from an employer and benefit payments from a superannuation fund were treated in the same manner. They were lumped together and treated as an Eligible Termination Payment (ETP) subject to Reasonable Benefit Limits (RBL).

From 1 July 2007, the legislation changed and superannuation payments were treated differently to payments directly from an employer. Employer payments were renamed Employment Termination Payment (ETP) and taxed differently.

TPD outside super

Let's look at two examples. In the first case study, Peter, aged 34, is an electrician who has been working for XYZ Pty Ltd since he was 18. His employer has purchased a group insurance policy outside of superannuation that provides a sum insured of $500,000 in the event of death or total and permanent disablement (TPD). The employer is the policy owner and beneficiary.

One weekend while driving his motorcycle, Peter is severely injured in an accident. Peter receives permanent injuries to his shoulders, knees and back. Peter's employer lodges a TPD claim via the group insurance policy. The life company receives satisfactory medical evidence that Peter will never work again based on his education, training or experience. The employer agrees that the client will not work again and pays Peter an employment termination payment of $500,000.

Peter is not entitled to the full sum insured of $500,000, as tax needs to be paid.

- TPD payment of $500,000
- Tax free amount = sum insured x (Days to retirement/total potential working life) = $500,000 x (11,324 / 17,168) = $329,800 (tax free)
- Taxable component = ($500,000 – $329,800) = $170,200
- Tax on taxable component = (($170,200 – $165,000) x 46.5%) + ($165,000 x 31.5%) = $2,325 + $51,975 = $54,300
- Net amount received = $500,000 – $54,300 = $445,700

** Includes Medicare Levy. Rates based on 2011–2012 financial year.*

It should be noted that where an employer provides trauma insurance and the employee is totally and permanently disabled, the same calculations as above will apply. In the event that trauma insurance is paid to the employee and there is no permanent cessation of work, the entire amount is taxable income to the employee. Alternatively, where trauma payments are due as compensation for personal injury, the payment will be non-taxable to an employee.

TPD inside super

If the same policy was held within the superannuation environment, again Peter would not be entitled to the full sum insured of $500,000, as tax needs to be paid.

- TPD payment of $500,000.
- Tax free amount = sum insured x (days to retirement/ total service period to age 65) = $500,000 x (11,324 / 17,168) = $329,800 (tax free)
- Taxable component = ($500,000 – $329,800) = $170,200
- Tax on taxable component = ($170,200 x 21.5%) = $36,593
- Net amount received = $500,000 – $36,593 = $463,407

** Includes Medicare Levy. Rates based on 2011–2012 financial year.*

The quote

If an employer makes a contribution to superannuation, which is then used to pay for insurance premiums, the entire contribution will be tax deductible to the employer and not subject to FBT.

It should be noted that in order to receive the tax free amount, certain conditions must occur. On 1 July 2007, sections 295–460 and 295–465 ITAA 1997 were introduced and stated that a tax deduction was available to the trustee of superannuation funds that provided disability superannuation benefits. At the same time, the definition of a disability superannuation benefit changed to become very specific:

- the benefit is paid to a person because he or she suffers from ill-health (whether physical or mental); and
- two legally qualified medical practitioners have certified that, because of the ill health, it is unlikely the person can ever be gainfully employed in a capacity for which he or she is reasonably qualified because of education, experience or training.

These provisions from the Tax Act are consistent with the SIS Regulations:

- two medical practitioners have certified, and the trustee is reasonably satisfied, that the member is unlikely because of ill-health (whether physical or mental), to engage in gainful employment for which the member is reasonably qualified by education, training or experience (s995–1 ITAA1997; SIS Regulations 6.01(2)).

If the member does not meet these strict definitions, then no tax free amount will be available. This would result in the entire benefit being taxed at 21.5% for someone under age 55.

Death cover outside super – dependant

In the second example, let's assume Peter was not so fortunate, and he dies as a result of his motorcycle accident. Peter's employer lodges a death claim via the employer's group insurance policy and pays Peter's wife an employment termination payment of $500,000. She will not receive the full sum insured of $500,000, as tax needs to be paid.

- Net amount received = $500,000 – (($500,000 – $165,000) x 46.5%)= $344,225

** Includes Medicare Levy. Rates based on 2011–2012 financial year.*

This means that more than $155,000 is taken in taxes.

Death cover outside super – non-dependant

Let's now assume that Peter is 48 years old. Peter's wife has predeceased him. Peter has one adult son named James who is 24. Upon death, Peter's death benefit from his employer group insurance plan (outside of super) gets paid to his "non-dependent" son James as an employment termination payment.

Net amount received = $500,000 – (($500,000 – $165,000) x 46.5%) – ($165,000 x 31.5%) = $292,250

** Includes Medicare Levy. Rates based on 2011–2012 financial year.*

This means that more than $200,000 is taken in taxes.

Death cover inside super – dependant

If Peter has the exact same level of cover inside super and his wife is the beneficiary, she will receive the full sum insured of $500,000, as the benefit is tax free.

Death cover inside super – non-dependant

If Peter did not have a wife or any dependants, and his death benefit from his superannuation fund was paid to his brother Paul, then taxes would need to be paid.

- Sum insured = $500,000
- Tax paid = ($500,000 x (11,324 / 17,168)x 31.5%) + ($500,000 x (5,844/17,168) x 16.5%) = $131,970
- Net amount received by non-dependant from super = $500,000 – $131,970 = $368,030

** Includes Medicare Levy. Rates based on 2011–2012 financial year.*

Income protection

Outside superannuation, if an employer owns an income protection policy on the life of an employee (normally via a group insurance arrangement), then upon receipt of the benefits from the insurance company, the employer can simply pass this benefit along to the employee as part of his/her normal remuneration.

Inside superannuation is a little bit more onerous. Superannuation Industry Supervision Regulations 1994 – Schedule 1 – Item 109, states that for the purposes of a temporary incapacity a person can commence a non-commutable income stream (i.e. not a lump sum) cashed from the regulated superannuation fund for the purposes of continuing (in whole or in part) the gain or reward which the member was receiving before the temporary incapacity, for a period not exceeding the period of incapacity from employment of the kind engaged in immediately before the temporary incapacity.

- The trust deed must allow the payment of a temporary incapacity benefit.
- Both employees and self-employed individuals qualify for this benefit.
- A member may be able to receive a partial disability benefit that replaces part of their income.
- Benefits must be paid at least monthly.
- A member has the right to replace up to 100% of their pre-disability income. Normally an income protection policy pays only 75%, but ancillary benefits (if available) may be used to fund the remaining 25%. A member may have an agreed value policy that pays 75% of their income at application, but the client needs to be careful if their income falls by more than 25% (i.e. change jobs, etc). Any excess benefits that would provide the client with more than 100% of their pre-disability income would be retained in the superannuation fund.
- A member would not be eligible for temporary incapacity benefits if they are receiving sick leave benefits, as this normally replaces 100% of pre-disability income.

- Benefits can only be paid for the period of incapacity. If the client is disabled for two months, but due to receiving a specific injury or a crisis benefit the superannuation fund receives a benefit that pays three months to 60 months, then the difference in the benefit (one month to 58 months) is retained within the fund. [Note: This possibility also creates issues regarding premium deductibility and (technically) deductibility would require an actuarial certificate.]

Pre disability income is easily defined by insurance companies under an income protection policy. Three common definitions are:

1. Highest average of monthly earnings for 12 consecutive months between two years before cover commenced and the start of the waiting period.
2. The greater of highest average monthly income in any consecutive 12 month period in three years immediately prior to disability; and average monthly income received during 12 months before application for present level of cover.
3. Highest average of monthly earnings for 12 consecutive months between one year before cover commenced and the start of the waiting period.

The SIS Act and SIS Regulations have not defined pre-disability income. Pre-disability income may be the income a person received over the past week, month, or year. Since there is no clarification, ambiguity exists. The problem is that if the client is unemployed, on sabbatical, on maternity leave, or a homemaker and not earning an income, they may not be entitled to any benefits from the superannuation fund, even if they have an agreed value policy. So the insurance company is still liable to pay the benefit to the superannuation fund, but the superannuation fund is not permitted to pay the benefit to the member#.

Taxation of income protection benefits

The taxation of income protection benefits, also known as salary continuance benefits, is the same whether the benefit comes from superannuation as a temporary incapacity benefit or from a group insurance plan outside of superannuation. The benefits are taxed at the individual's marginal tax rate in both circumstances (s 6–5 ITAA 1997; ATO ID 2002/175).

What about trauma insurance?

Unlike death, TPD and salary continuance cover, trauma premiums are not tax deductible to a superannuation fund trustee (ATO ID 2002/371).

The sole purpose test broadly limits the provision of superannuation benefits to a range of retirement, or retirement related circumstances. While the ATO has provided guidance on deductibility of trauma cover premiums for superannuation fund trustees, it has been left to APRA to determine the appropriateness of trauma cover in relation to the sole purpose test. APRA Superannuation Circular No.III.A.4 (The Sole Purpose Test – February 2001) provides the following guidance:

The trustee must determine whether the provision of trauma insurance by a superannuation fund trustee is acceptable, having regard to all the circumstances of the fund. This must be able to be substantiated if challenged by the auditor or APRA. Matters to be considered include the design of the trauma insurance and the manner and time in which the trustee intends to distribute any proceeds of the policy.

In determining whether to offer trauma insurance, trustees should consider their obligations to members generally and factors such as the proportion of contributions applied to purchase insurance cover. An unreasonable diversion of contributions as premiums for the contingent trauma cover would be difficult to reconcile with the sole purpose test and the fundamental retirement objective of superannuation.

If a superannuation fund fails to meet the sole purpose test, then trustees may be liable for criminal and civil proceedings (s62, s193, s197, s198 SIS Act). If a superannuation fund fails the sole purpose test, then all of the income and assets are taxed at 45% (s295-320; s26 Income Tax Rates Act 1986).

If there is an 'unreasonable diversion of funds' to pay for trauma premiums, the fund may breach the sole purpose test and become non-complying (ss 46–52 APRA Circular No. III.A.4). Regrettably, there has been no guidance on what constitutes unreasonable diversion of funds, whether it is a dollar amount or a percentage of contributions. This leaves the trustee in a precarious position of uncertainty. In the worst case scenario, if the fund is deemed to be non-complying then all of the income and the assets within the fund will be taxed at 46.5% – effectively losing half of the members' assets!

The quote

Unlike death, TPD and salary continuance cover, trauma premiums are not tax deductible to a superannuation fund trustee.

What does the future hold?

On 21 September 2011, Bill Shorten, Assistant Treasurer and Minister for Financial Services and Superannuation, issued the Stronger Super Information Pack. The Government addressed a number of issues regarding life insurance inside super.

Default insurance in MySuper products

MySuper products will be required to offer a standard, default level of life and TPD insurance.

Members of MySuper products will be able to increase or decrease their insurance cover (if offered by the trustee) without having to leave the MySuper product. This is consistent with current intra-fund advice provisions.

There may be particular factors at a workplace level which influence the appropriate amount and structure of insurance for employees at that workplace. Therefore, within a MySuper product, it will be possible for the standard insurance cover to be replaced by a default insurance strategy tailored to the specific requirements of the employees of a particular employer.

Term, TPD and income protection within superannuation

The Government has decided that trustees must allow members to opt-out of life and TPD insurance within 90 days of the member joining a fund, and on each anniversary of the member joining the fund.

If trustees are unable to obtain opt-out cover at a reasonable cost, trustees of MySuper products will be required to offer compulsory insurance.

Trustees of choice products can either offer compulsory insurance or no insurance.

The Government has decided that it will be left to the trustee's discretion whether to offer income protection insurance on an opt-in or opt-out basis, or at all.

The quote

The government has decided that trustees must allow members to opt-out of life and TPD insurance within 90 days of the member joining a fund, and on each anniversary of the member joining the fund.

Insurance policy definitions

Currently, some superannuation fund members are being charged premiums for insurance policies that may not meet an immediate condition of release when an insurance payment is made to the superannuation fund. The Government wishes to end this practice. The Government wants to align insurance definitions with the conditions of release so that insurance is consistent with the purpose of superannuation and that insurance monies are available to members at the time of their disability. The Government wants this change to be made as rapidly as possible to facilitate a phase-out of existing policies which are not consistent with SIS Act definitions of life, TPD and income protection insurance.

This means that any definition sitting within the super environment that does not meet strict SIS definitions will not be permitted. This will likely have the biggest impact on definitions of TPD within superannuation. Specifically, own occupation TPD will likely be banned. Other TPD benefits that will likely be affected are ancillary benefits such as: loss of limbs and sight, activities of daily living, and act of daily work. This new provision may also impact income protection benefits. Agreed value income protection policies may be affected, leaving only indemnity policies within superannuation. Also, it is likely that there will be a ban of ancillary benefits on income protection policies paid in the event of specified injury, critical illness, and rehabilitation benefits.

Trauma insurance will be banned in its entirety from being held within super; this is consistent with the recommendations that were in the Cooper Review and the Government's Stronger Super response in 2010.

Summary

It appears that insurance will be a significant part of any employee's benefits. With the proposed legislation, insurance benefits inside superannuation will be very prescriptive. This will provide certainty for members and superannuation trustees, but will provide little scope for innovation regarding policy definitions or features. For additional features, benefits or options, employers will need to consider policies outside of superannuation, but will need to be aware of the potential increased taxation liability – both for them and their employees. **FS**