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TOTAL & PERMANENT DISABILITY INSURANCE THROUGH SUPER

Strategies to protect your client

Linda Bruce

Personal insurance policies, such as death, total & permanent disability (TPD) and income protection insurance, are often held within super. In fact, more than 70 per cent of personal insurance policies in Australia are held through super funds (see Insurance through Superannuation, Rice Warner, April 2016)

The popularity of holding personal insurance in super is largely due to a range of benefits, including:

- Insurance premiums are often cheaper than outside super, as group super insurance policies are generally able to gain significant scale benefits, which can lower costs.
- Paying for insurance in super is more tax-effective. This is mainly because the insurance premiums can be funded by pre-tax contributions and the premiums are generally tax-deductible to the fund.
- The premiums can be funded by a member's super balance without affecting their cash flow. This makes insurance affordable for individuals with cash flow difficulties who otherwise would not be able to protect their lifestyle or that of their loved ones.
- Many super funds offer automatically accepted cover to members, without them having to go through medical underwriting. This can be appealing to members who have certain pre-existing medical conditions or work in high-risk occupations, however, it is worth noting the increased prevalence of 'pre-existing condition exclusion clauses' that exist in many automatic insurance cover arrangements.

Despite the benefits, there are a number of pitfalls that need to be considered when recommending insurance though super. In this article, we take a look at the pitfalls associated with TPD insurance through super and potential strategies advisers can use to overcome them.

Issues with 'own occupation' TPD insurance definitions

Since 1 July 2014, legislation requires that new insurance cover within super can only be taken out if the insurance definition is consistent with the super death, terminal medical condition, permanent incapacity or temporary incapacity conditions of release.

The quote

By rolling over the member's super disability benefit, including the accumulation amount, to a different fund, the crystallisation of the increase in the tax-free component can be triggered.

This is to ensure that in the event of a successful claim, the insurance pay-out can be accessed immediately. This also means an insurance cover that is not aligned with the conditions of release, such as, 'own occupation' TPD, 'agreed value' income protection and trauma cover, can no longer be issued within super. The policies in existence before 1 July 2014 may be able to be maintained under the grandfathering provision although some super funds have decided to apply this retrospectively to all members.

The 'own occupation' TPD cover can secure a higher chance of a successful claim. Initially, it appears this can be simply solved by holding such a policy outside super, however, the insurance premium can be more expensive and it is not tax-deductible.

The solution

Some insurers offer the ability to link life covers inside and outside super. The member can take out two linked TPD policies, with 'any occupation' TPD within super and 'own occupation' TPD cover outside super but only one TPD benefit amount is payable.

A claim will first be assessed using the 'any occupation' definition. If this is satisfied, the TPD benefit will be paid to the super fund. If not satisfied, the 'own occupation' definition will be assessed and if the claim is successful, the TPD benefit will be paid to the policy owner outside super.

The linked policies can avoid a duplication of insurance covers and the member can take advantage of the lower insurance premium rates without compromising the chance of a successful claim.

The portion of the premium payable within super is generally tax-deductible but the portion payable outside super is not tax-deductible.

Tax issues when TPD insurance is held within super

It is a common misconception that TPD insurance proceeds received by a member's super fund are paid tax-free to the member because they satisfy the 'permanent incapacity' condition of release.

TPD insurance proceeds paid for a successful claim are not taxable when they are received by the super fund, however, tax may apply when the benefits are paid by the super fund to the member.

Disability super benefits can be paid to a member as a lump sum or income stream and the relevant tax implications are summarised below:

Second, organisations fail to develop an internal environment that stimulates the growth and innovation they need to stay ahead.

They view their relationship with employees as a transactional quid pro quo and therefore struggle to find people who feel truly invested in their work and the organisation's future.

Age	Component	Tax on lump sum	Tax on income stream
Age 60 or over	Total benefit	0%	0%
Under preservation age	Tax-free	0%	0%
	Taxable – taxed	20% *	Marginal tax rate less 15% tax offset
Between preservation age and age 60	Tax-free	0%	0%
	Taxable – taxed	First 200,000^ at 0% excess at 15%*	Marginal tax rate less 15% tax offset

** Plus 2% Medicare levy where applicable*
^ This is a lifetime limit and indexed to AWOTE on 1 July each year

Disability lump sum benefits

The TPD insurance proceeds will initially form part of the taxable component in the fund. An increased tax-free component, in addition to any existing tax-free component, due to permanent incapacity can be calculated when:

- taking a benefit as a lump sum, or
- rolling over to another super fund.

This additional tax-free component reduces the taxable component of the lump sum, however, it is not automatically created when the insurer pays the insurance proceeds into the super account. It can only be calculated by the fund if the payment (lump sum withdrawal or rollover) is classified as a disability lump sum benefit by satisfying the criteria below:

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

It is important to note that as long as the above conditions are satisfied, the increase in the tax-free component can apply even if the member's fund did not receive a TPD insurance payout.

The increase in the tax-free portion of the disability super benefit is calculated as:

$$\text{Amount of benefit} \times \frac{\text{Days to retirement}}{\text{Service days} + \text{Days to retirement}}$$

Where:
Days to retirement = Number of days from when the person stopped being capable of being gainfully employed, to their last retirement date (usually age 65).

Service days = Number of days from the start of the eligible service period in the fund to the date the disability super lump sum benefit is paid to the member.

The Australian Taxation Office (ATO) has advised that in the formula's denominator, any days that are included in both 'service days' and 'days to retirement' are to be counted only once. Therefore, the denominator will always have the number of the days in the period from the service period start date to the last retirement date (usually age 65). This means regardless of when the disability benefit is paid, the uplift of the tax-free component of the disability lump sum remains the same. Otherwise any delay in paying the disability benefit could result in a lower tax-free component.
Product providers using the ATO's approach could result in a higher tax-free component.

Example 1

Jamayah, age 40 (born on 1 January 1978), has accumulated super benefits of $200,000 (with a 90% taxable component and 10% tax-free component). Her super fund record shows that her eligible period started on 1 January 2002.

Jamayah has $500,000 TPD insurance in her super. On 1 January 2018, Jamayah becomes permanently incapacitated due to an accident and the TPD insurance benefit is paid to her super.

Jamayah requests to withdraw $300,000 from her super as a lump sum on the grounds of permanent incapacity, to pay down her home loan. This payment satisfies the definition of a 'disability lump sum benefit' so an additional tax-free component of the payment will be calculated. The tax-free and taxable component of the lump sum super benefit is calculated by the fund using the below formula:

Jamayah needs to pay up to 22 % tax on the taxable component of $87,075 by withdrawing the $300,000 lump sum disability benefit.

Please note the remaining $400,000 is still made up of a 10% tax-free and 90% taxable component. The uplift in the tax-free component does not apply to the amount retained in the fund until another trigger event occurs, such as a lump sum withdrawal or rolling over to a different fund.

Step 1: Calculate the increase in the tax-free component

$$\text{Amount of benefit} \times \frac{\text{Days to retirement}}{\text{Service days} + \text{Days to retirement}}$$

Amount of disability super benefit = $300,000 (the withdrawal amount)

Days to retirement = 9,131 (1/01/2018 to 1/01/2043, her 65th birthday)

Service days = 5,844 (1/01/2002 to 1/01/2018)*

$$= \$300,000 \times \frac{9,131}{5,844 + 9,131}$$

= $182,925

**Note: Technically the service days should end on the day the benefit is paid. This calculation is based on the ATO's instruction that any days that are included in both 'service days' and 'days to retirement' are to be counted only once. Please note that the trustees of super funds may choose to adopt a different approach.*

Step 2: Calculate the tax-free component of Jamayah's lump sum withdrawal

Tax-free component = Step 1 result + existing tax-free component
= $182,925 + ($300,000 x 10%)
= $212,925

Step 3: Calculating the taxable component of the Jamayah's lump sum withdrawal

Taxable component = amount of benefit – tax-free component (from step 2)
= $300,000 - $212,925
= $87,075

Strategies to maximise the tax-free component

To increase the tax-free component, it is worthwhile considering the strategies below when recommending TPD insurance within super.

Placing insurance in a fund with shorter service days

Using the above formula to calculate the additional tax-free component, a longer service period relative to the total service period will result in a lower tax-free uplift. As such, it could be more tax-effective to place the TPD insurance in a super fund with a shorter period of service days.

Advisers need to beware that if a fund receives a rollover, the service period of the fund can be altered. The service days generally starts from the earlier of:

- the day the member joined the fund, and
- the service period start date of any rollover received by the fund.

It's a common strategy to rollover an amount from one fund to another, typically a risk only fund, to pay for the insurance premiums held in the second fund. If the first fund has an earlier service period start date, this date will be carried over with the rollover to the second fund and will become the service period start date of the second fund. This can result in a longer service period and a lower tax-free uplift of a disability lump sum benefit payment in the event of permanent incapacity (i.e. a higher amount of tax may be payable by the member).

Rolling over the disability benefit to a new fund before commencing a disability income stream

An increase in the tax-free component due to permanent disability can only be calculated when a lump sum benefit is paid. This means the payment must be taken as a cash lump sum or rolled over to a different fund.

Unfortunately, commencing a disability income stream within the same fund cannot increase the tax-free component. This is because the ATO consider this a 'transfer' rather than a rollover.

On the other hand, a member may want to roll over their super disability benefit to a different fund before commencing the income stream. This may be because the current fund does not offer an income stream, or the new fund is more appropriate for the member's needs. By rolling over the member's super disability benefit, including the accumulation

amount, to a different fund, the crystallisation of the increase in the tax-free component can be triggered.

Example 2

To continue with example 1, Jamayha commences an account-based pension in her current fund on the grounds of permanent incapacity with the remaining $400,000. The uplift in the tax-free component does not apply when the income stream is commenced in the same fund, so 90% of Jamayha's pension income will be a taxable component which will be taxed at her marginal tax rate with a 15% pension offset (non-refundable) while she is under age 60.

Alternatively, if Jamayha rolls over her disability super benefits from the existing super fund to another super fund before commencing the income stream, this will trigger the calculation for an increased tax-free component. Jamayha could then commence a disability income stream in the new fund and the taxable component of this income stream will be decreased from 90% to 29%.

Making non-concessional contributions into the fund before rolling over a super disability benefit

If a disabled member intends to rollover their super benefit to a different fund, make a non-concessional contribution to the new fund and then commence a disability income stream, they should make the non-concessional contribution to the original fund before rolling over the disability benefit to the new fund.

This is because the new contribution will result in a larger 'amount of benefit' in the formula to calculate the additional tax-free component. The larger 'amount of benefit' will result in a higher additional tax-free component based on the formula.

As such, it could be more tax-effective to make the non-concessional contribution into the original fund before rolling over the disability benefit to achieve a higher increased tax-free amount.

Example 3

Keegan is 45 years old. He has accumulated $250,000 in his super with a 100 % taxable component. His service period started 10 years ago.

He recently had an accident and became permanently incapacitated. He lodged a claim on his TPD insurance in his super. The claim was successful and his super fund received a $300,000 TPD insurance payout for him.

Keegan is not very happy with his current fund. He wants to rollover his super to a different fund, contribute $200,000 from a recent inheritance as a non-concessional contribution to the new fund and then commence an income stream to provide regular income.

On rolling over the $550,000 disability benefit to a different fund, the additional tax-free component is calculated as approximately $366,667 (i.e. $550,000 x 20 years/ (10 years + 20 years). After the new fund receives the $200,000 non-concessional contribution, it will end up with having a $566,667 tax-free component in total.

Alternatively, if Keegan makes the $200,000 non-concessional contribution to his current fund first, on rolling over the $750,000, the additional tax-free component will be calculated as approximately $500,000 (i.e. 750,000 x 20 years / (20 years + 10 years)[1]. After adding this additional tax-free component to the existing tax-free component of $200,000, the new fund will end up having a $700,000 tax-free component in total.

In comparison, the alternative strategy will provide an increase in the tax-free component of $133,333 by making the non-concessional contribution to the current fund first before the proposed rollover of the disability benefit.

Other considerations

Member's age

The formula used to calculate the additional tax-free component of a disability lump sum benefit means the closer the member is to age 65 when they become permanently disabled, the lower the 'days to retirement' number will be in the formula. The lower 'days to retirement' will result in a lower tax-free component.

This may not be a problem for the disabled member if they are already over age 60 as any super paid to a member over age 60 will be tax-free. However, for estate planning purposes, a re-contribution strategy may be considered if the beneficiary is a non-tax dependant.

Transfer balance cap

Unlike a personal injury super contribution, the TPD insurance payout received by a member's super fund is not excluded from being counted towards the member's transfer balance cap. This means the disabled member will not be able to move all their super accumulation balance (including the TPD insurance payout) into the tax-free retirement pension phase if it is over $1.6 million.

Centrelink

Unlike receiving a lump sum compensation payment, a disabled member is not subject to the Centrelink preclusion period when their super fund receives a TPD insurance payout on a successful TPD insurance claim. This member may be able to apply for the Centrelink Disability Support Pension (DSP) straight away and their carer may be eligible for the Carer Payment and Carer Allowance.

The member's super accumulation balance is not means tested if the member is under their qualifying age pension age. However, any super income streams are counted towards the assets test and deemed under the income test.

To maximise the disabled member's Centrelink DSP, it may be beneficial to retain the member's super in accumulation phase until they reach their qualifying age pension age. Of course, the potential increase in the DSP rates needs to be compared with the 15 % tax on investment earnings while the super is retained in the accumulation phase.

Conclusion

Holding a TPD insurance policy in super provides many benefits and remains a valuable strategy for clients to protect themselves and their loved ones. It is important to understand the advantages and disadvantages when recommending your clients hold TPD insurance in super.

Conducting regular reviews of insurance policies is also important as a change in a member's circumstances could mean considering a restructure of their insurances. **FS**

[1]Note: Strictly, the calculation should be done using the days in the relevant periods. For illustration purposes, we used years instead of days in this case study

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