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Stephen Miller is a Senior Technical Consultant with MLC Technical Services. Here he outlines a strategy, mainly available to SMSF clients, that involves using trauma insurance in super to top up income protection benefits in the event of temporary illness.

USING TRAUMA PROCEEDS TO TOP UP INCOME PROTECTION

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While holding trauma insurance in an SMSF has been a contentious issue for many years, APRA and the ATO have stated it can be done subject to certain caveats. This has created some opportunities for SMSF clients that could be used in limited circumstances.

One such opportunity is arranging for the SMSF to purchase a trauma insurance policy on behalf of the member(s) so the proceeds can be used to pay a non-commutable income stream (NCIS) under the temporary incapacity condition of release.

The income stream payments are then used to top up the member's income protection policy so that instead of receiving 75% of pre-disability income, the member is able to receive 100% of their pre-disability income during the period of incapacity. This strategy is primarily available to SMSF clients, as many retail funds do not permit trauma insurance to be held within superannuation.

How the strategy works

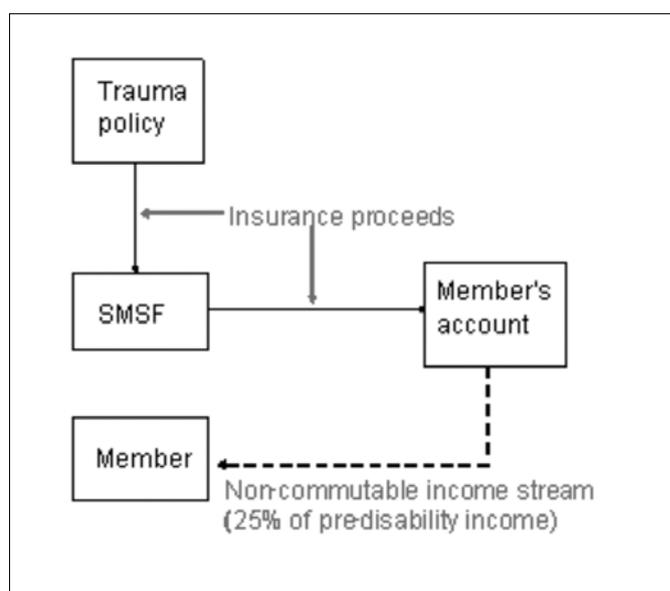
The legislation allows a super fund trustee to pay an amount from a member's account as a temporary incapacity benefit if this amount does not reduce the member's minimum benefits. APRA clarify this concept in Superannuation Circular No.I.C.1 Minimum Benefit Standards.

In this circular, APRA explain that "Consistent with the retirement income policy objectives of superannuation, SIS requires trustees to identify and maintain minimum benefits. Generally, minimum benefits in superannuation funds arise from member contributions, mandated employer-contributions, amounts rolled over or transferred in as minimum benefits and consequential earnings."

A trustee must ensure that a member's minimum benefits are maintained consisting of:

- rollover or transferred amounts
- employer-contributions
- plus investment earnings less costs

This means other amounts (including trauma insurance proceeds) added to the member's account do not form part of the minimum benefits and could be paid out under temporary incapacity.



The amount the trustee can pay as an NCIS depends on the member's pre-disability income. If the member has an income protection policy paying 75% of pre-disability income outside the super fund, the NCIS can be used to pay the additional 25% of pre-disability income, allowing the member to derive 100% of pre-disability income from the two sources. Once the member returns to full employment and earns their pre-disability income, any unused insurance proceeds must remain in the member's super account until another condition of release is satisfied.

Temporary incapacity

A trustee may pay benefits to a member who meets the definition of temporary incapacity. This means ill-health (whether physical or mental) that caused the member to cease to be gainfully employed, but does not constitute 'permanent incapacity'.

The payment of preserved and restricted non-preserved benefits under this condition can only be made as an NCIS. The payments from the income stream can only:

- continue for the period of temporary incapacity
- be for the purpose of continuing pre-disability income, and
- must not be paid from the member's minimum super benefits

Generally a member who is on fully paid leave (eg sick leave) would not be eligible to receive the temporary incapacity payment. In some cases, though, sick leave may be payable on a base rate of pay, with the employee having a higher rate of pre-disability income due to allowances and other payments. It is not necessary for the member to fully cease employment to be entitled to receive this benefit. Also, the trust deed must allow this type of payment to be made by the fund.

Taxation

Premiums paid for trauma insurance are not deductible to the fund. The NCIS payments are fully assessable at the member's marginal tax rate. There is no tax offset. This is because the NCIS is not considered a superannuation income stream.

Other considerations

Stronger Super reforms

The Stronger Super changes proposed a ban on trauma insurance in superannuation. If this measure is introduced it will impact this strategy. It is likely the Government will have transitional or grandfathering provisions to ensure clients can maintain existing cover, particularly as some clients may have difficulty obtaining new insurance due to health changes.

It is important to understand if the payments from the superannuation fund will impact other insurance payouts due to offset clauses. If there are offset clauses, the payment of the NCIS could negatively impact the strategy as the pre-disability income of 100% cannot be attained. Before implementing the strategy, it's important to review the member's income protection policy to determine if there is an offset clause. The ability to use this strategy may only be short term option, particularly as the rules may change.

Trust deed

The trust deed must not prevent the trustee from holding a trauma policy for the benefit of the member. The deed must also allow the trustee to pay an NCIS for temporary incapacity.

Trauma event

The proceeds from the trauma policy will only be paid under the events specified in the policy. A client may be temporarily unable to work but not have suffered a trauma allowing the policy to pay proceeds. If the trauma policy cannot be paid and the income protection policy can, the member will be limited to receiving up to 75% of pre-disability income (as stated in the income protection policy). This means the strategy will only work in certain circumstances.

Implementation costs

The cost of implementing this strategy must be considered. In many cases the trust deed of the SMSF must be reviewed, which may involve legal fees. The cost of trauma cover must also be considered. Funding trauma premiums through super could be beneficial for a client, as salary sacrifice or other employer contributions may be used to pay the premiums.

Payment of premiums and sole purpose test

The ATO released SMSF Determination 2010/1 to provide guidance in this area. The determination indicates that a trauma policy can be owned by an SMSF without automatically breaching the sole purpose test. However, the ATO could still have scope to consider individual circumstances and deem the sole purpose test was breached. APRA has issued similar guidance through

Superannuation Circular No.III.A.4 The Sole Purpose Test.

The sole purpose test requires that an SMSF be maintained for one or more of the core purposes (eg retirement savings) and specified ancillary purposes (eg permanent incapacity). The determination includes a number of provisions and states trustees must give consideration to the proportion of contributions applied to paying the trauma premiums.

The ATO considers an 'unreasonable diversion' of contributions towards a trauma policy would be inconsistent with the sole purpose test. The phrase 'unreasonable diversion' is not defined in the determination and leaves scope for the ATO to consider individual circumstances.

No guidance is provided if premiums are paid from fund assets rather than contributions. Individual circumstances would be considered to determine if the fund has breached the sole purpose test. The ATO will consider all aspects as to why the trustee has acquired the insurance including:

- whether the policy was purchased to obtain a benefit for another person such as a member or member's relative (eg lower premiums on other policies), and
- compliance with other regulatory requirements.

Conclusion

There is scope to use a trauma policy to pay an NCIS under the temporary incapacity condition of release. The circumstances may be limited due to the definition under income protection and trauma policies. It does provide scope for client who needs 100% pre-disability income to ability to implement a strategy to achieve that goal. **FS**