Trauma insurance – is it necessary and should it be provided via superannuation?

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HOW MUCH IS ENOUGH?

The current maximum sum insured for trauma insurance policies in Australia is $2 million, so any answer is always limited by this amount. The first question should not be, “how much is enough?” but rather, “what do I need the benefits for?”

The financial planner’s role is to gather and analyse information about the client and their needs so they can determine what life insurance cover is required to minimise the risk of the client not attaining their financial goals. Each client will have unique circumstances, so each analysis will be different. Regardless of differences, there must be a logical basis for the recommendation so the adviser can substantiate the advice provided if challenged.

When you look at the other types of life insurance available, there are specific needs that are normally taken into consideration.

For death cover (term insurance), a client normally considers personal issues such as: debt reduction, educational expenses, lump sum to replace income, final expenses (funeral), and estate equalisation; while for business needs a client considers: debt reduction, key person cover, and business succession funding.

Total and permanent disability cover allows a client to eliminate debt and cover ongoing capital and revenue expenses associated with severe disability relating to personal needs; while, like term insurance, the business needs for TPD are: debt reduction, key person cover, and business succession funding.

Income protection insurance allows the client to protect their lifestyle, while business expense insurance allows a business to pay overheads associated with running a business.

The position is currently quite different when trauma insurance is considered. The need for trauma insurance is less predictable, and will depend on the type of illness or injury suffered. An adviser needs to be aware of the likelihood of an event occurring and will there be a significant financial impact if the event occurs. The significant financial impact may be incurred by the life insured, their family or their business. Let’s look at incidence rates for various types of conditions covered by trauma policies.
<table>
<thead>
<tr>
<th>Insured event</th>
<th>Incidence rates per 100,000</th>
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<tbody>
<tr>
<td></td>
<td>Male</td>
</tr>
<tr>
<td>Cancer</td>
<td>14,400</td>
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<tr>
<td>Heart attack</td>
<td>12,000</td>
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<tr>
<td>Stroke</td>
<td>4,500</td>
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<tr>
<td>By-pass surgery, angioplasty</td>
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<tr>
<td>Cardiomyopathy</td>
<td>1,800</td>
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<td>Deafness, blindness</td>
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<tr>
<td>Lung failure</td>
<td>1,100</td>
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<tr>
<td>Valve/aorta repair/replacement</td>
<td>850</td>
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<tr>
<td>Parkinson’s Disease, Alzheimer’s Disease,</td>
<td>790</td>
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<tr>
<td>other dementia</td>
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<tr>
<td>Head trauma, liver failure</td>
<td>660</td>
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<tr>
<td>Kidney failure</td>
<td>470</td>
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<td>Organ transplant, multiple sclerosis,</td>
<td>250</td>
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<tr>
<td>paralysis</td>
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<tr>
<td>Motor neurone disease</td>
<td>170</td>
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<tr>
<td>Severe burns, occupational acquired HIV</td>
<td>60</td>
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<tr>
<td>Aplastic anaemia, pulmonary hypertension,</td>
<td>25</td>
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<tr>
<td>coma, encephalitis, loss of limbs, loss of speech</td>
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TRAUMA INSURANCE PURPOSE

The purpose of trauma insurance is to provide a lump sum payment if the insured suffers a major medical trauma so that the insured can achieve what’s needed at that time. This may be to obtain the best possible medical care, to gain access to rehabilitation, or to make any desired lifestyle changes.

Lifestyle changes may include: debt reduction, time off work, pre-fund children’s education, pre-fund superannuation, holiday, emergency fund, discretionary home improvements, purchase of retirement home, home care or cleaner, or funding early retirement.

While 90 per cent of trauma insurance claims are a result of cancer, heart attack and stroke (CommInsure 2008), other events do occur and must be considered.

If a client has a family history of particular diseases, or a client is involved in particular high risk pastimes, then it may be worthwhile considering the impact of these events (i.e. paralysis for a client involved in sports, or Alzheimer’s for an insured with family history).

The estimated costs for out of pocket medical expenses and rehabilitation for major traumatic conditions are: heart attack $15,000; cancer $60,000; stroke $75,000; paralysis $1.5 million; and dementia $300,000. If these are the potential medical costs, then how much are the lifestyle costs?

DEBT REDUCTION

Debts should be extinguished as directed by a client. If income protection and TPD are unavailable, the repayment of total debt should be given serious consideration. As a starting point, it is worth considering that the average Australian mortgage is $215,100 and the average credit card debt is $2,200.

PRE-FUND CHILDREN’S EDUCATION

As the client may still earn an income post a trauma incident, there are no minimum requirements for calculating income into the level of trauma cover. However, if income protection and TPD cover are not available, the client may consider this as a separate item if private or tertiary schooling is required. It should be noted that it could cost parents more than $20,000 per annum in total costs per child for secondary education.

MEDICAL AND LIFESTYLE COSTS

A reasonable amount for this purpose would be the greater of $50,000 or 100 percent of the major earner’s annual income, as agreed with the client. This would provide for out-of-pocket medical expenses not covered by Medicare and private health insurance, as well as lifestyle requirements such as household modifications and adjustments.

HOLIDAY AND MODIFICATIONS TO HOME

This amount would allow for additional expenses to assist the insured in the recovery and rehabilitation process over and above those provided for under medical and lifestyle costs. These may not be necessary, but it is still worth having a discussion with the client. Considering that holidays and possible home modifications can both cost thousands of dollars, this is worth talking over with clients.

EMERGENCY FUNDS

As for recovery income, this would be calculated based on a percentage of the major earner’s income. These funds would be earmarked to provide for short-term unforeseen expenses.

FUNDING EARLY RETIREMENT OR PRE-FUNDING SUPERANNUATION

Where the client has adequate income protection and TPD cover, or income protection and TPD cover is being recommended, this may not be required. The rationale behind this is that some income protection policies have superannuation continuance benefits that make contributions to superannuation while disabled.

Alternatively, if the client is seriously disabled then TPD benefits may be able to fund this requirement. But this scenario should be taken into consideration when determining a sum insured.

If the client is working, and income protection is of limited duration or unavailable due to their employment history or if the client does not qualify for TPD cover, it is reasonable to cover 100 percent of annual income until retirement age.
REALISABLE ASSETS
These are assets that the client or clients will be disposing of upon the occurrence of a trauma event. In most cases, clients would likely retain most their assets, as these are likely to remain part of their investment portfolio to support them if they need to retire early.

EXAMPLE 1
George (aged 42) and Jennifer (aged 40) are married and have teenage children, aged 18 and 14.
Jennifer is a golf professional, who provides lessons and does some tournament work around the country, and earns around $80,000 per year.
Due to her occupation as a golf professional, Jennifer is ineligible for TPD cover or income protection, but will be accepted for trauma cover. George and Jennifer have a mortgage of $120,000 but no other debts. How much trauma cover does Jennifer require?
As Jennifer cannot get TPD or income protection cover, she should use trauma cover to make up the shortfall. We need to assume the worst-case scenario, namely that Jennifer would be totally and permanently disabled as a result of a trauma event.
We also need to bear in mind that she may become permanently disabled but not qualify for a trauma benefit; for instance, as a result of mental illness or a chronic back condition. In this case Jennifer would need to rely on personal savings to cover any costs.
During the fact-find process, you determine that Jennifer would require 60 per cent of her income ($48,000) until age 65 if she were disabled and there were no debts. The Excel calculation would be as follows:

\[ \text{Calc} = 1.04 \times (1-(1.04)^{-30})/0.04 \]

The above formula produces a factor of 16.2469631413969, which is multiplied by $48,000 to produce a lump sum of $779,854. The calculation takes into consideration inflation and assumes that the life insured will earn 4 per cent in excess of inflation with their investments.

### Total trauma recommendation for Jennifer

| Requirements to repay liabilities | $180,000 |
| Medical/lifestyle                | $80,000  |
| Emergency funds                  | $0       |
| Recovery income                  | $0       |
| $50,000 until age 65 for Emily   | $779,854 |
| **Total trauma requirement**     | $1,039,854 |

Trauma insurance has evolved from its original purpose of providing for medical expenses associated with critical illness or injury. The amount of cover is greatly influenced by the availability of both income protection and Total and Permanent Disability cover.

Now that we have discussed how much trauma insurance is enough, the next question that needs to be addressed is where should the trauma insurance be placed, inside or outside of superannuation?

TRAUMA INSURANCE OUTSIDE SUPERANNUATION
Over the past 25 years, advisers have usually placed trauma insurance outside of superannuation. By having trauma insurance outside super, the client only needs to meet the insurance policy definition to obtain a benefit payment.

For individuals who own a policy on their own life, the taxation is quite straightforward. Premiums are not tax deductible – refer Section 8-1 Income Tax Assessment Act 1997 (ITAA1997) – while the benefits are tax free (refer ss118-300, 118-37, ITAA 1997).

In situations where an employee owns the policy, but has a benevolent employer who will pay the premiums, the benefits are tax-free.

The employer can claim a tax deduction for the premiums paid on behalf of the employee, but these premiums will attract fringe benefits tax (FBT).

Where an employer owns a policy on a key employee, taxation will depend upon how the benefits are used. If the benefits will be used for a capital purpose within the business (i.e. repay loans or debts, etc) the premiums will not be tax deductible and the benefits will be taxed as a capital gain to the business. If the benefits will be used for a revenue purpose within the business (i.e. operating expenses, salaries, recruitment, training, etc), the premiums will be tax deductible and the benefits will be taxed as income to the business.

TRAUMA INSURANCE INSIDE SUPERANNUATION
Over the past 12 months, the life insurance industry has seen an increase of life insurance being written within superannuation. Due to the elimination of reasonable benefit limits (RBLs) on 1 July 2007, more people have recognised the attractiveness of funding life insurance premiums via superannuation.

Generally, the insurance inside superannuation has been limited to term and TPD, but some individuals are looking at placing trauma cover inside their super as well.

Normal contributions to superannuation often receive tax incentives. These incentives may include government co-contribution payments, deductions for spouse contributions, and deductions for concessional contributions from employers or salary sacrifice.

Payment of trauma premiums from superannuation contributions is perceived to be more attractive than payment of trauma premiums from after tax dollars outside superannuation, as the incentives mentioned above are not available outside the superannuation environment.

TAXATION OF TRAUMA PREMIUMS WITHIN SUPERANNUATION
Premium affordability is often the key motivator that attracts individuals to place their insurances via superannuation. Unlike death, TPD and salary continuance cover, trauma premiums are not tax deductible to a superannuation fund trustee (ATO ID 2002/371). This means that concessional (deductible) contributions to fund trauma premiums could be subject to contributions tax in the fund. Even with this result, it may still be tax effective to fund trauma premiums via superannuation, given that such premiums are generally not tax deductible outside of superannuation.
EXAMPLE 2

Dexter is a 40 year old self-employed computer programmer. Dexter runs his business through a company. Dexter will draw a salary of $150,000 this year. Superannuation contributions are made by his company to a self managed superannuation fund that has investments, death cover and TPD cover.

Dexter requires $500,000 of trauma cover.

He wants to determine if he should own the trauma cover either outside of superannuation or within his SMSF. Trauma cover via CommInsure’s Total Care Plan policy with a $500,000 sum insured will cost $1,232.26 for the first year.

If the policy were owned outside of superannuation, this amount would come from Dexter’s after tax earnings. At a marginal tax rate of 41.5 per cent (including Medicare levy), Dexter would need to earn $2,106.43 (pre tax) to afford the premium of $1,232.26 (after tax).

If the policy was owned by Dexter’s SMSF, his company could reduce his salary by the pre tax equivalent of this amount $2,106.43 and contribute this amount to superannuation.

This would reduce Dexter’s after tax income by $1,232.26 (the same as the cost of the trauma policy). This concessional contribution would be taxable in his SMSF at a rate of 15 per cent ($2,106.43 x 15 per cent = $315.96) leaving $1,790.47 in the fund before the payment of the trauma premium.

From this amount, the fund could pay the premium on the trauma policy of $1,232.26, leaving Dexter an extra $558.21 for investments in the fund.

Alternatively, Dexter’s company could pay the superannuation fund only the trauma premium grossed up for contributions tax, of $1,449.72 ($1,232.26 / (1 -0.15) = $1,449.72).

The remaining $656.71 ($2,106.43 – $1,449.72 = 656.71) is paid to Dexter as normal salary.

After tax at a rate of 41.5 per cent on the $656.71, leaves Dexter with an extra $384.18 in his hand compared to him funding the trauma cover outside of superannuation.

THE SOLE PURPOSE TEST

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 SMSF trustees, it has been left to APRA to determine 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.

This is very ambiguous! If the trustee is diverting an “unreasonable amount of funds” to pay for trauma premiums, this may breach the sole purpose test – possibly making the fund non-complying.

If the fund is non-complying all of the assets and the income of the fund will be taxed at 46.5 per cent! The problem is that neither the ATO nor APRA have given any guidance on what is considered to be “unreasonable”. Superannuation fund trustees should seek their own advice as to whether or not, in the circumstances unique to their own fund, the sole purpose test is satisfied where fund assets are used to pay trauma premiums.

ACCESSING TRAUMA BENEFITS FROM SUPERANNUATION

In order to receive a benefit from a superannuation fund, a member must generally have satisfied a condition of release, including retirement after preservation age, transition to retirement, or attaining age 65. A person may also satisfy a condition of release where they are permanently incapacitated.

A person is permanently incapacitated where a superannuation fund trustee is reasonably satisfied that the member is unlikely, because of physical or mental ill health, to engage in gainful employment for which the member is reasonably qualified by education, training or experience.

Where a trauma policy owned by a superannuation fund pays benefits upon the life insured suffering a trauma event, the policy proceeds would be payable to the superannuation fund. However, the proceeds could not be paid to the member until they satisfied a condition of release, which may be retirement after their preservation age. Suffering a trauma condition is not necessarily a condition of release.

If the design of the trauma policy is such that it is unlikely that the trustee of the superannuation fund can release the proceeds of the trauma payment to the member after receipt from the insurance company, this too may breach the sole purpose test, possibly making the fund non-complying and in extreme cases forcing the fund to pay 46.5 per cent tax on all assets in the fund.

It may, therefore, be inappropriate for clients to fund trauma cover via superannuation where they require immediate access to such benefits following a successful claim if they have not already satisfied a condition of release, or are close to being able to satisfy a condition of release.
TAXATION OF TRAUMA PROCEEDS

The ATO has not provided any guidance on whether or not trauma proceeds paid to a superannuation fund will be subject to CGT in the fund. However, the case for taxing these benefits in the hands of the trustee cannot be dismissed out of hand – especially where they cannot be shown to become payable to the member in the shorter term.

As the trauma insurance payment to the superannuation fund would be taxed as a capital gain, this would diminish the available benefit by almost 15 per cent. In the case of Dexter, where he has $500,000 in trauma insurance via superannuation, this could mean that when the life insurance company pays the superannuation fund, $75,000 is lost in CGT, leaving only $425,000 in the fund.

Trauma benefits received from a superannuation fund will be taxable as a normal superannuation living benefit.

A member may be eligible for an invalidity component on payment of a superannuation living benefit, only where that member terminates employment because of disability and where two legally qualified medical practitioners have certified that the disability is likely to result in the person being unable ever to be employed in a capacity for which that person is reasonably qualified because of education, training or experience.

Suffering a trauma condition will, therefore, not necessarily create a tax free invalidity component.

If Dexter meets his condition of release under permanent incapacity, then it is worthwhile to determine how much of the trauma benefit he will receive.

Assuming that the fund has already paid the $75,000 in CGT, the remaining $425,000 will still incur tax when paid to Dexter. Depending upon his eligible service period, and his date of disablement, he may pay up to 21.5 per cent tax or as little as nil.

Let’s assume that Dexter suffers a major stroke at age 53, and his eligible service date commenced at age 20 – in this case he would have to pay an additional $67,008 in tax leaving a lump sum benefit of only $357,992 for Dexter.

This position should be compared to the taxation of trauma policy proceeds on a policy owned outside of the superannuation environment. Non-superannuation trauma proceeds are generally paid tax-free where paid to the life insured or a relative of the life insured.

CONCLUSION

While it is possible to have trauma cover via a superannuation fund, such ownership will not be appropriate in all circumstances. Although tax deductibility of contributions to superannuation is attractive, it hides a nasty sting in the tail – taxation of member benefits and potential breach of the sole purpose test.

What is the solution? Keep trauma insurance outside superannuation. It may not be as beneficial to tell a client that they cannot claim a tax deduction for contributions, but it provides certainty for the client to know the sum insured is the exact amount they will receive at claim time.

1 Australian Institute of Health and Welfare – Australia’s Health 2008;
Australian Government – Department of Health and Aging – Help with Aged Care – What will I pay?;
Arthritis – the bottom line. The Economic Impact of Arthritis in Australia (2006 Arthritis Australia);
Is Injury Compensation Excessive? (Peter Abelson – 2003);
Cancer Council NSW – 6 April 2007;
The Burden of Cardiovascular Disease in Australia for the Year 2003 (Heart Foundation 2007);
How We Measure Stroke in Australia (Australian Institute of Health and Welfare – February 2006);
Physical Disability Council of NSW – Cost of Disability Income Support;
2 ABS, 4102.0 – Australia Social Trends – 2008
3 Reserve Bank of Australia, 2008