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SUPER REFORM: IMPLICATIONS FOR HOLDING LIFE COVER THROUGH SUPER

Stuart Sheary

The recent super reform changes makes it an opportune time to revisit how life cover in super should be funded as well as how it should be paid to eligible beneficiaries from super upon death.

From 1 July 2017, advisers have additional considerations when recommending life cover through super. These include:

Funding of premiums

- removal of the 10% rule
- reduction in the concessional and non-concessional contribution cap
- reduction in the income threshold for Division 293 tax
- increased spouse contribution tax offset income threshold.

Death benefit payment

- removal of anti-detriment payment on member benefits
- removal of the 'prescribed period'
- introduction of the pension transfer balance cap.

Funding premium issues

While it may be possible to fund life cover with a client's existing super balance or super guarantee contributions without making a personal contribution, the client's balance may be eroded. For this reason our analysis will assume that premiums are funded via super contributions.

Removal of 10% rule

The removal of the 10% maximum earnings condition has made it possible for employees to claim a tax deduction on personal super contributions. It might be easier to make a personal deductible contribution rather than setting up a salary sacrifice arrangement. This change can make it easier to fund life cover premiums through super with concessional contributions but it should be noted that it is necessary to lodge the valid Notice of intent to claim a deduction form with the fund within the necessary timeframes prescribed in section 290-170 of ITAA 1997. Specifically, clients will need to ensure that they provide the notice to the trustee and receive acknowledgement from the trustee **before the earlier of**:

- lodging their income tax return for the financial year in which the contribution was made
- 30 June of the financial year following the contribution
- commencement of an income stream based in whole or part of the contribution
- any lump sum withdrawal is made
- any amount is rolled into a new fund

Reduction in concessional contribution cap

The reduction in the concessional contribution cap to $25,000 means additional concessional super contributions to fund life cover premiums may be restricted.

From 1 July 2018, clients may be able to accumulate the unused concessional cap and use the accumulated unused amount up to five financial years later. This change means clients face a trade-off

The quote

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between using part or all of their concessional contribution cap in a particular year over using that concessional amount in a future year. For example if in the current financial year a client is expected to be on the 34.5 per cent tax bracket (including Medicare levy) they may benefit from making a concessional contribution, however, the client may benefit more by saving their concessional amount if in a subsequent year they expect their marginal tax rate to increase to 47 per cent (including Medicare levy).

Reduction in the non-concessional contribution cap

Those who are already contributing up to the maximum concessional contribution cap may need to make non-concessional contributions (NCCs) to fund their premiums. Some clients may also be limited in their ability to make NCCs with the reduction in the NCC cap to $100,000 per year or nil where their total super balance is $1,600,000 or more as at 30 June of the prior financial year. Remember that your client's total super balance is the sum of their accumulation interests, pension transfer balance or modified transfer balance as well as any rollover amount in transit.

Reduction in the Division 293 income threshold

The reduction in the Division 293 income threshold from $300,000 to $250,000 means more clients will be liable for this tax. The additional 15 per cent tax will make it less beneficial for affected clients to make concessional contributions to meet insurance premiums.

Spouse contribution

A tax offset may be available to clients who make a NCC contribution to their spouse's super. Funding life cover in super via spouse contributions may be a tax-effective alternative to concessional contributions. The recent increase in the receiving spouses' income cut out threshold from $13,800 to $40,000 means more contributing spouses will be eligible for a tax offset.

Payout issues

A potential reduction in your client's personal tax liability by making concessional contributions into super will need to be weighed against any taxation of life cover proceeds which will reduce the net proceeds received by the beneficiary.

Cover held personally

Capital gains tax (CGT) will not ordinarily apply on the proceeds from term life cover. CGT will only apply where the beneficiary was not the original beneficial owner and had acquired the interest for consideration, i.e. they had made some form of payment for the policy, section 118-300 of ITAA 1997. This means cover held personally will ordinarily be received by the beneficiary tax-free.

Cover held through super

Term life cover proceeds paid to the trustee of a super fund are exempt from CGT, however, the subsequent death benefit paid from super will include the insurance proceeds, which may be taxable. The actual tax liability will vary depending on the type of benefit being paid, who it is being paid to and the underlying tax components of the fund.

Dependants

For a beneficiary to receive a super death benefit directly from super they must be a super (SIS) dependant. SIS dependants may receive the death benefit as a lump sum or income stream (some exclusions apply for children).

In the case of a child of the deceased death benefit pensions are restricted to:

- a child under 18
- a child under 25 who is financially dependent upon the deceased
- a child with a disability of the kind described in subsection 8(1) of the Disability Services Act 1986

Whether the beneficiary is a tax-dependant will determine the tax (if any) payable on the death benefit.

The table below summarises beneficiaries who are classified as tax-dependants and SIS dependants.

Beneficiary	Tax	Super
Spouse	Yes	Yes
Former spouse	Yes	No
Child under age 18	Yes	Yes
Child age 18 or over	No	Yes
Financial dependant (including dependent adult child)	Yes	Yes
Interdependent relation	Yes	Yes

The changes from 1 July 2017 present opportunities and pitfalls which should be considered before recommending how benefits should be withdrawn.

Phase out of anti-detriment payment

Anti-detriment payments are not available where the deceased passed away after 30 June 2017. Where the deceased passed away prior to 1 July 2017 an anti-detriment payment may only be available if the death benefit lump sum is paid before 1 July 2019 to an eligible beneficiary.

While no anti-detriment amount is calculated on insurance proceeds, where the deceased had an existing balance many dependant beneficiaries who were entitled to an anti-detriment payment, namely spouses, elected to take a lump sum over an income stream. This change reduces the incentive to take a death benefit lump sum over an income stream.

Removal of the prescribed period

The removal of the prescribed period provides dependant beneficiaries the ability to withdraw tax-free lump sums, regardless of age, from a death benefit income

stream at any time. The prescribed period was generally the later of six months from date of death or three months from date of probate. Before 1 July 2017, lump sums drawn outside the prescribed period were taxed as member benefits meaning they may have been taxed at up to 22 per cent (including Medicare levy).

This change will be positive for beneficiaries in receipt of a death benefit income stream who are below age 60 and where the deceased was less than 60 at date of death. In this situation the beneficiary in receipt of the death benefit income stream may elect to receive any amount in excess of the minimum pension payment as a tax-free death benefit lump sum. Furthermore lump sum withdrawals will have the added benefit of creating a debit on the beneficiary's transfer balance account. Where the beneficiary later decides to commute the pension in full the benefit will be tax-free rather being taxed at up to 22 per cent (including Medicare levy).

Pension transfer balance cap

Earnings on assets supporting a 'retirement phase' income stream, which is broadly an income stream with nil cashing restrictions, are tax-free. Pension payments will also be tax-free if either the surviving client or the deceased (at the time of their death) are or were age 60 or over. Otherwise the taxable component of the income stream will be taxed at marginal rates less a 15 per cent tax offset. A death benefit income stream may be a tax-effective way for a dependant beneficiary to receive the insurance proceeds.

If the death benefit, including life cover proceeds, is paid as a new income stream to a dependant, the starting value of the income stream will count towards the beneficiary's pension transfer balance cap. Alternatively, where a reversionary pension reverts to a beneficiary the value of the automatic reversionary pension as at date of death will be credited to the beneficiary's transfer balance account 12 months from the date of death, although modifications do apply for minor children. The pension transfer balance cap will limit beneficiaries' ability to commence or maintain an income stream in retirement phase using their own super.

This change is particularly relevant to clients with a large sum of life cover within super as well as members who have already used some or all of their pension transfer balance cap. These clients may have to have their super benefits paid out as a death benefit lump sum which may not have been the original intention when the cover was first acquired.

Minors

A death benefit income stream paid to a minor child will not affect the child's ability to commence an income stream in retirement. This is achieved through a modified pension transfer balance cap.

Where the deceased had a retirement phase income stream sometime before the time of their death, the child's modified pension transfer balance cap will be their proportional entitlement to the deceased's income stream(s).

Where the deceased does not have a transfer balance account at the time of their death, the child's modified pension transfer balance cap is their proportional interest in the deceased's accumulation interest multiplied by the general transfer balance cap.

Example of multiple beneficiaries

Let us assume that Jane has $2,000,000 in life cover inside super and has not yet commenced a retirement phase income stream. Upon death this life cover is added to her existing member balance of $200,000 thus totalling $2,200,000 that must be paid out as a death benefit to her SIS dependants.

Her nominated beneficiaries include her spouse, (Henry), and her minor child, (Susan). If Henry is paid a death benefit income stream for $1,600,000 and the remainder, $600,000 (27 per cent of Jane's super death benefit), is left to Susan the most that Susan can receive as a death benefit income stream is $436,363 (27 per cent of the general transfer balance cap). The remainder, $163,637, must be received as a death benefit lump sum.

Caution required as there may be the creation of an untaxed amount on death benefit lump sums

A death benefit lump sum containing insurance proceeds where the fund had claimed a deduction on insurance premiums may contain an untaxed element. An untaxed element may adversely affect a non-tax dependant beneficiary, such as an adult child, as the maximum tax rate on this component is 32 per cent, including the Medicare levy. Tax dependants such as a spouse or minor child are not adversely affected by the creation of an untaxed element as the death benefit lump sum will be tax-free regardless of its components.

This untaxed element is calculated according to the prescribed formula in section 307-290 of ITAA 1997 and is not a function of the proportion of insurance proceeds. A death benefit paid on a younger client with fewer eligible service days will generally have a larger untaxed element. A death benefit lump sum paid on an older client with more eligible service days will generally have a smaller untaxed element. For example, a client with insurance in super who dies over 65 will not have any untaxed element.

Despite the creation of an untaxed element it may still prove economic to both the insured and beneficiary to hold life cover through super.

Example – holding life cover in super can be very economic

Tim earns a salary of $60,000 a year and is on a marginal tax rate of 34.5 per cent, including the Medicare levy. He intends to leave $500,000 to his adult son Steven who is a non-tax dependant. To achieve this he will acquire life insurance and seeks advice as to whether to hold the life cover through super or own it personally.

The quote

Reduction in your client's personal tax liability by making concessional contributions into super will need to be weighed against any taxation of life cover proceeds.

The quote

The pension transfer balance cap will limit beneficiaries' ability to commence or maintain an income stream in retirement phase using their own super.

The quoted annual premium for $500,000 of life cover for Tim is $1,250 per year.

If Tim is willing to forgo $1,250 of after tax income to finance life cover he can make a personal deductible contribution of up to $1,908.1 Assuming the fund claims a deduction on the life cover the deduction will reduce the fund's assessable income to the extent that there will be no 'contributions tax' on the contribution. This means the full $1,908 is available to fund a premium which will buy life cover for $763,200 (assumes $1 purchases $400 in life cover). To this end Tim can purchase $763,200 in cover within super, which will leave him in the same after-tax cash flow position.

	Personally owned	Super non-concessional	Super concessional contribution
Cover	$500,000	$500,000	$763,200
Premium	$1,250	$1,250	$1,908[1]
After tax cost	$1,250	$1,250	$1,250
Gross payout	$500,000	$500,000	$763,200
Taxable - taxed	n/a	$333,333[2]	$508,800
Taxable - untaxed	n/a	$166,667[2]	$254,400
Tax	Nil	$110,000	$167,904
Net proceeds	$500,000	$390,000	$595,296

[1] *$1,250/(1-marginal tax rate) or $1,250/(1-0.34.5), rounded to the nearest dollar*
[2] *Assumes Tim is age 50, eligible service start date was 30 years prior to date of death, retirement at age 65 and super fund claims a deduction on premiums*

The results suggest that the best outcome for Steven would be for Tim to hold the cover through super and make concessional contributions to fund the premiums. Funding cover through super with non-concessional contributions would lead to the worst result. The absence of a personal tax deduction means the level of cover acquired will be the same as the amount that can be acquired personally however unlike personally held life cover the super death benefit paid to Steven will be taxed.

Tax dependants

In comparison, if Tim had elected for a tax dependant, e.g. his spouse Jane, to receive a super death benefit lump sum no tax would apply to the payment and she could receive a super death benefit of $763,200 where premiums were funded through concessional contributions. This is $263,200 more compared to a policy held outside of super.

Furthermore where the intended beneficiary is a SIS dependant the ability for the beneficiary to receive an income stream (some exclusions apply to children) might be preferred.

Summary

Now is an opportune time to review clients with existing life cover and confirm the most appropriate method of ownership.

The tax-effectiveness of funding premiums through super will vary depending on many factors, some of which may be affected by the recent super reform changes. These changes may also have a bearing on how benefits may be received.

A consideration of the merits of holding life cover personally or through super may substantially benefit your client and their loved ones. **FS**

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