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TPD claims within superannuation

Taxation pitfalls of consolidation

Andrew Reynolds

An unintended consequence of the *Treasury Laws Amendment (Protecting Your Superannuation Package) Act 2019* (PYSP Act) that came into effect on 1 July 2019 means that many total and permanent disability (TPD) insurance claimants may have significantly higher tax rates when they access their TPD benefits, potentially costing them tens of thousands of dollars in additional tax.

On 21 April 2020, the Australian Prudential Regulation Authority released data showing there were 17,500 group TPD insurance claims approved via members' superannuation accounts in 2019. Many of these claimants may be surprised and disappointed to learn that when they come to access these TPD proceeds from their superannuation account, they will have to pay a significant amount of tax when accessing their TPD benefit.

The PYSP Act and inactive superannuation accounts

One element of the legislation requires "inactive low-balance accounts" (that is, superannuation accounts with balances under $6,000 that have had no contributions for at least 16 months) to be rolled over to the Australian Taxation Office (ATO) every six months (on 31 October and 30 April each year). The ATO will then direct these proceeds into an "active" superannuation account that the member holds.

The first tranche of rollovers happened on 31 October 2019 and will continue to occur every six months. An unintended consequence of this legislation is that some TPD claimants will have a significantly higher tax rate when they access these funds.

Tip

One thing members should never do when they are pursuing a TPD claim is to consolidate superannuation accounts because this can increase the tax they pay when they then withdrawal these funds from superannuation—which has to do with how tax is calculated on "disability superannuation payments" prior to retirement age. Through this legislation, many TPD claimants will fall into this trap through no fault of their own.

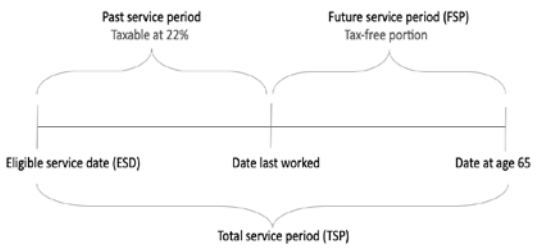
Tax treatment of disability superannuation withdrawals

When a TPD claim held through superannuation is approved, the proceeds are then paid into the member's superannuation account and combined with their existing balance. When meeting the TPD definition, the member also meets the superannuation "permanent incapacity" condition of release (these two definitions are aligned), meaning their superannuation becomes unrestricted, non-preserved and they have full access to their superannuation/TPD money.

If the member then makes a withdrawal from their superannuation

account before preservation age (between 55 and 60, depending on when a person was born), they will pay tax at a rate of 22% on the taxable component. When accessing funds under permanent incapacity, there is a 'tax-free uplift' calculation applied, which means a portion of the superannuation withdrawal amount will be tax free (see Figure 1).

Figure 1. Tax-free uplift calculation timeline



Source: Created by author

New tax-free component = existing tax-free component + withdrawal amount x FSP/TSP

The tax-free uplift calculation means every TPD claimant will have a different effective tax rate. Further, those members with multiple superannuation accounts and TPD claims will have a different effective tax rate when they access funds from each superannuation account.

Eligible service date

Every superannuation account has an eligible service date (ESD), which is either the earlier of the following dates:

- The date the superannuation account was set up.
- If the superannuation account was set up by an employer, it is the date of commencing employment with that employer.
- If superannuation accounts are consolidated, the earlier ESD is always retained.

It is this third point that can unknowingly cost TPD claimants a substantial amount of additional tax—with the PYSP Act, many claimants will be impacted.

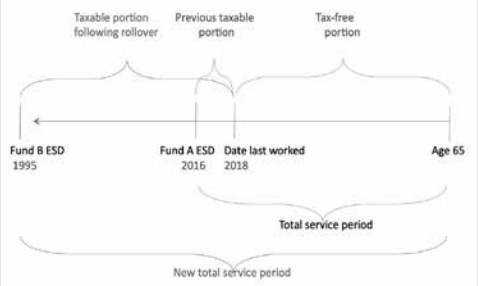
Example 1. Consolidation: how an earlier ESD can increase tax

Scott, 45, commenced his Fund A account in January 2016, and ceased employment in March 2018. He has a TPD claim of $500,000 approved through his Fund A superannuation account. If Scott withdraws his $500,000 TPD balance, he will pay tax of $10,000 (2%). Scott also had a Fund B account which he commenced in 1995.

This account has a balance of $3,000.

Given this Fund B account is inactive, Fund B has written to Scott to let him know about this situation and that the balance will be rolled over to the ATO and consolidated with an active superannuation account. If Scott's Fund B account gets rolled into his Fund A account and he then withdraws his TPD balance, the tax he will pay is $55,000 (11%). This is a $45,000 increase in tax (see Figure 2).

Figure 2. How consolidation lengthens the total service period



Source:Created by author

What can TPD claimants do about this?

Consider

If someone is thinking about submitting, or has submitted, a TPD claim and they have more than one superannuation account, they should *not* consolidate superannuation accounts without understanding the tax and other financial consequences.

Often, submitting a TPD claim triggers the claimant to take a more active role regarding their superannuation accounts. Many people think they are doing the right thing through consolidation (this does not bring any additional insurance benefits), which is sensible for many fund members. However, for TPD claimants this could be very costly.

If the potential TPD claimant has an inactive low-balance superannuation account, there is an ATO form that they can completed and lodged with their superannuation fund to ensure it does not roll over their account to the ATO. Unfortunately, this needs to be undertaken every six months, before each cut-off date (1 October and 31 March).

Strategies and further considerations for TPD claimants

Before TPD claimants access their insurance benefit, they should understand that they have options, and there are specific strategies that can reduce their tax. These are examined in the following discussion.

The quote

When a TPD claim held through superannuation is approved, the proceeds are then paid into the member's superannuation account and combined with their existing balance.

Rolling over superannuation to lock in tax-free component

The previously outlined tax-free uplift calculation is only applied when the superannuation member makes a withdrawal or *rolls* over their superannuation benefit. This means that if the member leaves their TPD benefit within the fund and decides to make a withdrawal at a later date, the superannuation fund may ask for updated medical certificates in future to ensure the member still meets the "permanent incapacity" condition of release.

If they are unable to provide the medical certificates, or if they have returned to work, the member can still withdraw their funds (as they have been classed as non-preserved), but they will pay the full 22% tax rate and not receive the tax-free uplift amount.

A simple strategy to avoid this situation is for the member to roll over their superannuation benefit to another superannuation account. This rollover is classed as a "disability payment" and, therefore, the existing superannuation fund will provide details to the new superannuation fund of the tax-free component.

This means the member gets to lock in their tax-free component. It also means that in future, the member can make withdrawals from their superannuation account any time and have the lower tax rate locked in, even if they return to work.

Non-concessional contribution before rollover 'washes out' the taxable component

If the TPD member has access to other funds and can make a non-concessional contribution into their superannuation account where the TPD claim has been approved and then rolls this account over to another superannuation account, it will increase the power of the tax-free uplift. This means the member can have a significantly reduced tax rate on future withdrawals. In some cases, they can 'wash out' the taxable component completely, meaning the member's superannuation account is 100% tax free.

Segregating superannuation accounts and TPD claims

Quite often, Australians have more than one superannuation account and, therefore, have multiple TPD claims. As outlined earlier, each of these accounts will have a different tax rate on withdrawal.

This means that claimants may want to choose which account they access funds from, based on this tax rate. It also means that if the claimant is rolling over their superannuation accounts to lock in taxable components, they may want to keep accounts separate so they can access funds initially from the lower-tax-rate account; and then higher-tax-rate account is earmarked for withdrawal in future, possibly over age 60, when superannuation withdrawals are tax free.

Account-based pensions

As TPD claimants have met the permanent incapacity condition of release, they also have the ability to commence an income stream (account-based pension (ABP)) with their superannuation benefit(s).

If the member is under retirement age, this has completely different tax treatment. ABP income is taxable at marginal tax rates, with a 15% disability tax offset. So, depending on the claimant's situation (that is, any other taxable income/benefits they may be receiving), they may be able to draw a significant income through an ABP with minimal or no tax.

A potential strategy to further reduce tax is to roll over the superannuation benefit, lock in the tax-free portion, then supply two new medical certificates to the new superannuation account and receive the 15% tax offset. This means the member can withdraw quite a high annual income (often in excess of $100,000 per financial year, if they have no other taxable income).

Implementation and tax reduction versus tax avoidance

First, all the aforementioned strategies should not be implemented for tax reduction purposes alone, but as part of an overall strategy. Second, all superannuation funds are not the same, and having an experienced financial adviser implement these strategies is crucial.

Example 2. Disability payments and rollovers

Going through the normal channels to process a rollover (that is, using SuperStream) often results in the tax-free uplift not being applied on rollover. It is much safer to provide a rollover form directly to the superannuation fund with a covering letter requesting the tax-free uplift to be applied and that the rollover be classed as 100% unrestricted, non-preserved.

Conclusion

TPD claims through superannuation have unique tax treatment, and claimants face numerous potentially costly pitfalls if they do not understand their options. However, they also have unique opportunities to maximise their benefit and financial position if they choose the right strategy by using an adviser with the requisite skills. FS