Dr Jeffrey Scott, MetLife Australia

Dr Jeffrey Scott is head of advice strategy at MetLife Australia. He is a regular commentator on insurance, superannuation, pensions and finance, and has lectured at the University of Technology Sydney and UNSW. Jeffrey created the first terminal illness benefit for life insurance products in Australia, helped develop lump sum income protection benefits, and introduced full income replacement coverage. His qualifications include a Bachelor of Mathematics, Diploma of Financial Planning, Master of Education, Master of Taxation Law, and Doctor of Philosophy in Taxation.

TPD insurance inside and outside superannuation

Tax and net benefits

Dr Jeffrey Scott

Advisers are often asked whether or not a client should own their total and permanent disability (TPD) policy individually (self-owned) or have it structured via a superannuation fund where they are a member. When comparing the pair, the answer may come as a surprise. Let's explore.

In order to compare 'apples with apples', we will assume that the policies being considered in the examples in the following sections of this paper are TPD policies that would meet the common "any occupation" definition, and thus also meet the permanent incapacity definition condition of release under the *Superannuation Industry (Supervision) Regulations 1994* (SIS Regulations) (SIS Regulation 1.03C, & Schedule 1, item 103), superannuation disability benefit (section 995-1 of the *Income Tax Assessment Act 1997* (ITAA)), and the definition of compensation for injury or illness (ITAA section 118-37).

Deductibility of premium payments by the individual

First, where the life insured owns a TPD policy on their own life (outside superannuation), the life insured may not claim a tax deduction for the premiums paid (ITAA section 8-1). This means that the premiums are paid in after-tax dollars. For an individual who is on the highest marginal tax rate, this means that they must earn $1,886.79 in order to afford a $1,000 premium.

If the life insured has structured a TPD policy so that it is owned by the trustee of the superannuation fund where they are the member, depending on how they then pay for premiums, they may be cheaper due to potential tax deductions:

1. If the member pays the premium with non-concessional contributions (NCCs), then the net tax result to the life insured is no different if they are on the highest marginal tax rate and paying a premium for policy outside superannuation (i.e. ordinary policy).
2. Where a member makes a concessional contribution to the fund, this will normally attract contributions tax except where the contribution is used to pay for an insurance premium (ITAA sections 295-460 to 295-495). In order to pay a $1,000 premium in a superannuation fund, a member can make a $1,000 concessional contribution, and claim a tax deduction at their marginal tax rate (ITAA sections 290-10, and 290-155). This is subject to the $25,000 concessional contribution cap from all sources for the 2020/21 financial year (superannuation guarantee, voluntary employer contributions, salary sacrifice, and personal concessional contributions—ITAA sections 280-10, 280-15, 290-60, 290-65, 290-80, 290-85, 290-150, 290-165, 290-170, 290-175, 290-180, 291-15, 291-20 and 291-25).

3. A third alternative is when a member chooses to roll over the amount of the premium from a superannuation fund where they are an existing member, to a different superannuation fund where their life insurance is owned by the trustee—in this circumstance, the member is not entitled to a tax deduction.

What is the impact of each of these scenarios at claim time?

First, where a life insured owns a policy on their own life (outside superannuation) and they are also the beneficiary of the policy, then the TPD benefit will be paid from the life insurance company to the life insured tax free (ITAA sections118-37 and 118-300). It will also be paid tax free if the TPD benefit is paid to a defined relative (ITAA sections118-37 and 995-1).

If the TPD benefit is paid to somebody who is not the life insured or a defined relative, then the benefit will normally be treated as a capital gain to the recipient (ITAA section 104-35; Taxation Ruling 95/35 *Income tax: capital gains: treatment of compensation receipts*). The gain will be the sum insured less any premiums paid, and may be subject to capital gains discounting if the policy has been held for more than 12 months.

For the case where the life insured purchased a policy with a sum insured of $1 million, if they became totally and permanently disabled, then they will receive a TPD benefit from a life insurance company of $1 million (subject to meeting the terms and conditions of the policy).

Second, if the life insured has structured the policy so that it is held by the trustee of a superannuation fund where they are a member, then it becomes far more complicated. In the first instance, expect to pay some tax. The tax may be as little as nil or as much as 20% (plus Medicare levy).

The variables that influence the rate of tax are numerous, and include:

- sum insured
- age of life insured at date of disablement
- date the money is withdrawn from the fund
- when the life insured became a member of the fund
- if the life insured rolled in a pre-service period
- years to retirement.

If the same life insured, let us all call him Fred, was to have the same $1 million sum insured in an insurance-only superannuation fund (no accumulated assets) and then became totally and permanently disabled, how much tax would be withheld by the superannuation trustee? It depends.

Example 1

If Fred joins the fund at age 18 and suffers a terrible accident the day after he joins, where he is totally and permanently disabled, then the calculation would look like this:

TPD payment from insurance company to superannuation fund = $1,000,000

Tax-free amount modification for disability benefits = sum insured x (days to retirement/(service days + days to retirement)) = $1,000,000 x (17,154/17,155) = $999,941

Taxable component = $1,000,000 – $999,941 = $59

Tax on taxable component = $59 x 20%* = $11

Net benefit paid to member = $1,000,000 –$11 = $999,989

*Does not include Medicare levy.

(ITAA sections 301-35, 307-65, 307-120 and 307-145; SIS Regulation 6.01)

Example 2

If Fred joins the fund at age 18 and suffers a terrible accident at age 56 (prior to preservation age), where he is totally and permanently disabled, then the calculation would look like this:

TPD payment from insurance company to superannuation fund = $1,000,000

Tax-free amount modification for disability benefits = sum insured x (days to retirement/(service days + days to retirement)) = $1,000,000 x (3,285/17,155) = $191,489

Taxable component = $1,000,000 – $191,489 = $808,511

Tax on taxable component = $808,511 x 20%* = $161,702

Net benefit paid to member = $1,000,000 – $161,702 = $838,298

*Does not include Medicare levy.

(ITAA sections 301-35, 307-65, 307-120 and 307-145; SIS Regulation 6.01)

Example 3

If Fred joins the fund at age 18 and suffers a terrible accident at age 59 (after preservation age), where he is totally and permanently disabled, then the calculation would look like this:

TPD payment from insurance company to superannuation fund = $1,000,000

Tax-free amount modification for disability benefits = sum insured x (days to retirement/(service days + days to retirement) = $1,000,000 x (2,190/17,155) = $127,659

The quote

Where a life insured owns a policy on their own life (outside superannuation) and they are also the beneficiary of the policy, then the TPD benefit will be paid from the life insurance company to the life insured tax free.

Taxable component = $1,000,000 – $127,659 = $872,341

Tax on taxable component = ($872,341 – $215,000) x 15%* = $98,601

Net benefit paid to member = $1,000,000 – $98,601 = $901,399

*Does not include Medicare levy.

(ITAA sections 301-20, 307-145 and 307-345 of the ITAA 97; SIS Regulation 6.01)

Example 4

If Fred joins the fund at age 18 and suffers a terrible accident at age 62 (after preservation age), where he is totally and permanently disabled, then the calculation would look like this:

TPD payment from insurance company to superannuation fund = $1,000,000

Tax-free amount = after age 60 all benefits released from superannuation to the member are tax free

Tax on taxable component = nil

Net benefit paid to member = $1,000,000

(ITAA section 301-10)

Example 5 (a nasty sting in the tail)

If Fred joins the fund at age 50 and suffers a terrible accident at age 56 (prior to preservation age), where he is totally and permanently disabled, then the calculation would look like this:

TPD payment from insurance company to superannuation fund = $1,000,000

Tax-free amount modification for disability benefits = sum insured x (days to retirement/(service days + days to retirement) = $1,000,000 x (3,285/5,475) = $600,000

Taxable component = $1,000,000 – $600,000 = $400,000

Tax on taxable component = $400,000 x 20%* = $80,000

Net benefit paid to member = $1,000,000 – $80,000 = $920,000

*Does not included Medicare levy.

This assumes that Fred pays his premiums by concessional contributions or NCCs. If Fred pays his premiums by a rollover from a fund where he was a member from age 18, then the calculations are not quite so advantageous.

TPD payment from insurance company to superannuation fund = $1,000,000

Tax-free amount modification for disability benefits = sum insured x (days to retirement/(service days + days to retirement)) = $1,000,000 x (3,285/17,155) = $191,489

Taxable component = $1,000,000 – $191,489 = $808,511

Tax on taxable component = $808,511 x 20%* = $161,702

Net benefit paid to member = $1,000,000 – $161,702 = $838,298

*Does not included Medicare levy.

This results in the member receiving $81,702 less because the premium was paid via a rollover.

Is it possible to reduce the tax impact?

Is there any way for Fred to reduce the tax to nil? Yes, but it may be difficult for many clients to facilitate. The member of the superannuation fund would need to make an NCC to the superannuation fund *prior* to the superannuation trustee releasing the benefits from the fund to the member.

Example 6

In this example, we are going to change the parameters. The sum insured is reduced to $400,000, and the member of the superannuation fund has made an NCC of $300,000 some time prior to the trustee releasing the TPD benefits to the member.

If Fred joins the fund at age 50 and suffers a terrible accident at age 56 (prior to preservation age), where he is totally and permanently disabled, then the calculation would look like this:

TPD payment from insurance company to superannuation fund = $400,000

NCCs made to the fund still in accumulation phase = $300,000

Assume there are no earnings in the fund.

Tax-free amount modification for disability benefits = (sum insured + NCCs) x (days to retirement/(service days + days to retirement)) = ($400,000 + $300,000) x (3,285/5,475) = $420,000

Tax-free component = tax-free amount modification for disability benefits + NCCs = $420,000 + 300,000 = Revised to $700,000* ($720,000)

Tax on taxable component = (amount of benefit – tax-free component) x 20% = ($700,000 – $700,000) x 20%* = nil

Net benefit paid to member = $700,000 (including NCCs)

(This assumes that Fred pays his premiums by concessional contributions or NCCs)

(ITAA sections 307-120, 307-125, 307-145 and 307-400)

Are there any other alternatives?

Yes, the life insured could begin to receive an income stream that is taxed at the member's marginal tax rate less a 15% tax offset, until the member turns 60, after which time the income stream is tax free (ITAA sections 301-25 and 301-40).

Otherwise, if the member delays receiving the TPD payment (that is, lets the TPD insurance benefit remain in the superannuation fund) until after the member turns age 60, then the lump sum would be tax free (ITAA section 301-10).

Summary

When it comes to TPD insurance, deciding whether to hold insurance inside or outside of superannuation will depend on each person's individual circumstances.

When it comes to holding TPD insurance inside superannuation, it may be nice to receive a tax deduction for paying TPD premium via a concessional contribution to superannuation, or it may be convenient to simply roll over money from another superannuation fund to pay for a premium. Both situations have different tax implications for a member who has a successful TPD claim paid from a trustee of a superannuation fund.

Alternatively, owning a TPD policy outside of superannuation results in no tax deductions for the premiums, but also results in no tax liability at claim time. **FS**