MAKING INCOME PROTECTION MORE AFFORDABLE FOR CLIENTS

By the AIA Technical and Education Centre of Excellence (TECE) team

HEALTHIER, LONGER, BETTER LIVES

July 2022

With household debt continuing to increase, and the ever growing reliance on an individual's personal exertion income to service this debt, there has never been a more important time for Australians to consider income protection (IP) insurance. However with living costs increasing (including the cost of IP cover), many clients are questioning the value of this type of cover against other household expenses.

As an adviser, you play an integral role in helping your clients manage both their cash flow and their potential risks. Rather than a client cancelling their IP cover altogether, there are a number of strategies you could consider to make IP more affordable.

One of the simplest methods of reducing IP premiums rates is to extend the waiting period. But that doesn't necessarily mean it's the right solution for them. For example, a 90 day waiting period, instead of 30, means that even though the client will pay less, there will be an extra two month wait after becoming incapacitated before they receive their insured monthly benefit. Clients who have limited liquid assets or cash flow may struggle with the longer waiting period option.

In this paper, we explore how the super law provides a niche opportunity to plug an anticipated cash flow gap during an extended waiting period.

Temporary incapacity condition of release

Super law1 prescribes which components of a super account can be accessed upon a member's temporary disablement. In broad terms, these components include the proceeds of an IP policy and any voluntary contributions (made via an employer) above compulsory super guarantee (SG) contributions.

In other words, if a client has historically salary sacrificed salary/wages to their super fund, they technically have grounds to request a release of those contributions (plus associated earnings) via a non-commutable income stream following total and temporary disablement. The amount released must not result in the member exceeding the trust deed's prescribed level of pre-disablement income (PDI) and nor can payments be made beyond the period of temporary disability. The ability to draw on these benefits could facilitate a longer IP waiting period.

"One of the simplest methods of reducing IP premiums rates is to extend the waiting period."

Is it workable in practice?

While the legislation provides the scope, traditionally this has proven difficult to administer because super funds wouldn't typically receive, nor request, the information required to distinguish between an SG and salary sacrifice contribution.

However, that administrative limitation is somewhat narrowed with the advent of SuperStream. Most employers must now pay super contributions for employees electronically (EFT or BPay) and send associated data electronically. More importantly, part of this associated data provides information detailing whether the employer contribution includes a salary sacrifice component.

In practice, this is likely to be more achievable for clients operating an SMSF, assuming that the fund's trust deed provides the necessary latitude and that the SMSF administrator is on board. It relies on the employer specifying – say via the applicable SuperStream system – the salary sacrifice component of the contribution being remitted electronically and this must be recorded and tracked by the SMSF administrator going forward.

1 Regulation 5.08(3) of the *Superannuation Industry (Supervision) Regulations 1994* provides the legislative scope for a member to access salary sacrifice contributions from their superannuation fund upon meeting the temporary incapacity condition of release definition.

Planning opportunity

So theoretically, if the fund trust deed and policy/processes permit it, a member may be able to access salary sacrificed contributions during an extended waiting period upon the occurrence of temporary disability. This could in turn allow for a longer waiting period, thereby lowering the client's IP premiums, potentially without compromising on cash flow (but noting the super PDI and duration limitation and amount of salary sacrificed contributions that can be identified and made available for withdrawal).

Consider a client that earns $100,000 per annum, or $8,333 PDI per month. A self-owned IP policy is triggered with a 90 day waiting period. If the client had previously accumulated a minimum of $25,000 in salary sacrifice contributions (say as part of an existing contribution savings plan), they may be in a position to replace their monthly pre-tax PDI of $8,333 over the 90 day period (assuming no other sources of income).

Flow on effects

For self-owned policies, a lower premium reduces the direct cost to the client. For super-owned IP cover, a lower premium means less deterioration on retirement savings – an issue highlighted by ASIC in Report 413.

For completeness, we note that the legislation effectively allows only salary sacrificed contributions to be accessed in this manner. This means any personal tax deductible contributions made into super cannot be accessed.
A potential workaround for self-employed clients could involve salary sacrifice contributions (in excess of mandatory SG contributions) from an associated private company or trust – subject to expert tax advice.

Finally, existing IP policies may require a cancel and replace if the waiting period changes. In such cases, expert advice should be obtained from the product provider to ensure that any loss of benefit(s) is understood and will be disclosed to the client.

Summary

In general, superannuation members are able to access salary sacrificed contributions upon temporary disablement. Realistically, such access may be limited to members of SMSFs. If the SMSF administrator can facilitate it, (and trust deed permitting), the ability to pay some salary continuance benefit from their super fund could enable a client to choose a longer IP waiting period on their insurance policy. That's a win-win for the client. They could receive the benefits that a comparatively shorter waiting period provides but still lower the cost of their IP cover, without compromising on their cash flow during a temporary absence from work.