TOTAL AND PERMANENT DISABILITY (TPD) IN SUPERANNUATION

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Placing insurance cover in the superannuation environment results in different planning opportunities, tax outcomes and governing rules compared with owning insurance directly in a client's own name. It can also be a confusing topic for clients, especially when it comes to the possible benefit payment options. In this case study, we look at Total and Permanent Disablement (TPD) insurance in superannuation and the possible outcomes and opportunities available to clients if a claim is paid.

A TPD superannuation case study

Richie is a member of AIA Insurance Superannuation Scheme No2, through which he has taken a Priority Protection Total and Permanent Disablement (TPD) policy.

At age 50, Richie suffers a serious injury at work which prevents him from working ever again. AIA Australia pays the insured amount of $1,000,000 to the trustee of the AIA Insurance Superannuation Scheme No2, the owner of his TPD policy. Despite being under preservation age, Richie has access to the benefit as he meets the permanent incapacity condition of release under superannuation law, converting the full balance to unrestricted non-preserved.

Withdraw lump sum

Richie requests to withdraw the entire TPD benefit from his superannuation account to his personal bank account.

Listed below are the pros and cons of this decision:

Pros	Cons
There's a degree of **transparency** and **simplicity** because the proceeds will presumably be invested in Richie's own name (e.g. within a term deposit, cash management trust etc.) compared to the complexity associated with superannuation investments.	AIA Insurance Superannuation Scheme No2 is required to **withhold tax at 22%** (including Medicare Levy) on the *taxable component – taxed element*[1] before paying the lump sum to Richie.
Richie is not exposed to any future superannuation and related taxation **legislative risk**.	Richie will pay tax on any future investment income generated by the capital, at his marginal tax rate.
Part of Richie's balance may be **converted** into a tax-free component[2] when the lump sum is paid. This calculation is covered by tax law, and recognises his permanent disability prior to his assumed retirement age of 65[3]. This tax-free component uplift reduces the proportion of the lump sum that is assessable for income tax purposes.	Future entitlement to **social security** support (e.g. Disability Support Pension) may be impacted, because the amount invested in his own name will be means tested. Any remaining capital is likely to form part of Richie's estate on his death, which may be subject to creditor or family provision **claims**.

1 TPD claim proceeds are initially paid as 100% taxable component – taxed element but may be converted based on a formula as outlined in footnote 3.
2 Conversion is based on a legislated formula and is not automatic. Richie must provide the trustee of the fund two medical certificates certifying his permanent incapacity prior to cashing out the lump sum as per ITAA 1997 s995.1 "disability superannuation benefit" definition.
3 Calculation defined in ITAA 1997 s307.145

Can Richie retain this amount within superannuation?

Richie is not obligated to withdraw a TPD benefit from superannuation; however, as the AIA Insurance Superannuation Scheme No2 is a risk only superannuation product, the TPD benefits from the Scheme can only be paid to the client as a cash lump sum or rolled over to a superannuation fund with an investment/accumulation component.

Accumulation Phase

Rather than withdrawing the entire amount from his superannuation, Richie can retain the proceeds in accumulation phase by rolling over his funds to a superannuation fund with an investment component. As he has met the superannuation law's permanent incapacity condition of release, Richie's superannuation is 100% unrestricted non-preserved and he is therefore eligible to withdraw lump sums from his superannuation account.

Pros	Cons
Investment income and realised capital gains are taxed at 15% instead of Richie's personal marginal tax rate.	Not all superannuation funds offer a regular withdrawal facility from an accumulation account, potentially increasing administration for regular payments.
Funds will be unrestricted non-preserved, allowing lump sum withdrawals or commutations to pension phase at a later date.	Richie is exposed to future superannuation and related taxation legislative risk.
Funds invested in accumulation phase are not assessable for Centrelink means testing purposes for individuals under age pension eligibility age.	

Pension phase

Having met the superannuation fund's condition of release, Richie could use part/all of the proceeds to start a pension. The pension payments could provide day-to-day cash flow for Richie's living expenses as well as being a tax-friendly vehicle for the $1,000,000.

Here are the pros and cons of Richie opting for a disability superannuation benefit (TPD) pension:

Pros	Cons
By rolling over part/all of the $1,000,000 to another superannuation fund to commence a TPD superannuation pension, part of Richie's balance will be **converted into a tax-free component**[4]. This calculation is provided under the tax law in recognition of his permanent disability prior to his assumed retirement age of 65, reducing the proportion of each pension payment that is assessable for income tax purposes.	While Richie is under age 60, the taxable component – taxed element portion of his pension payments may be taxable at his marginal tax rate, less the 15% tax offset due to his permanent incapacity. Payments are tax-free from age 60.
Richie receives a **15% tax offset** on the taxable component of pension payments (to age 60) due to his permanent incapacity. Payments are tax-free from age 60.	The requirement to draw a minimum pension payment reduces the amount invested in the superannuation environment over time.
Tax-free investment income and realised capital gains on fund assets supporting the superannuation pension.	Capital transferred to pension phase is bound by the $1,700,000[5] transfer balance cap.
Ongoing full access to capital, and future lump sum withdrawals permitted.	Richie's social security entitlements may be reduced because the balance of superannuation held in pension phase is subject to means testing.
On Richie's death, any balance remaining in his superannuation fund account may be paid directly to his superannuation dependants, keeping the proceeds outside of his estate.	Richie is exposed to future superannuation and related taxation legislative risk.
No withholding taxes levied by the superannuation fund at time of rollover to another taxed superannuation fund.	

4 In contrast, this conversion does not occur when a TPD superannuation pension is commenced straight out of the fund that initially received the insurance proceeds. In other words, the conversion to tax-free component is only triggered when the trustee pays a lump sum to the member or when a rollover to another superannuation fund is made.

5. Note, clients that have already commenced an income stream prior to 1 July 2021 will have a transfer balance cap between $1,600,000 and $1,700,000, depending on their highest ever balance of their transfer balance account. This can be worked out by performing a calculation.

Pension versus lump sum

Realistically, a client's financial circumstances may require the immediate withdrawal of some or all of the proceeds from their superannuation – debts or medical expenses may need to be paid or the client may simply prefer to have the money in their bank account. Regardless, any lump sum withdrawal prior to age 60 may result in the fund withholding tax, and this should be factored into client discussions.

The objective of this case study is to increase awareness of the options available when a claim on TPD occurs in the superannuation environment. One or a combination of the options above may be suitable for your client. Payment and structuring options should be considered as part of the TPD benefit payment method discussion. Superannuation may provide the client with a tax effective structure to house insurance proceeds without compromising cash flow and future social security entitlements.

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