INCOME PROTECTION: INSIDE OR OUTSIDE SUPERANNUATION OR SOMETHING IN BETWEEN?

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Losing the ability to earn an income to fund living expenses could run down savings levels and cause financial difficulty. As an adviser, you play an integral role in helping your clients recognise the importance of income protection and help them to manage their cash flow and any potential risks. However, for many clients the decision to hold income protection insurance comes down to affordability.

But what should your clients consider when deciding on how to structure their income protection cover? When thinking about whether insurance should be held inside or outside of superannuation, it is important to note that some of the key features remain the same, such as:

- Premiums are generally tax deductible under both ownership structures
- The after-tax cost of the premiums is the same for the client under both structures, and
- Upon claim, monthly benefit payments are taxed at the client's marginal tax rate under both structures as payments are considered 'ordinary income'.

This article will address the key differences between the two ownership options and look at how linked insurance policies may provide clients with the best of both worlds.

Superannuation-owned income protection

Most superannuation funds offer insurance for their members. There are many benefits of this ownership structure however clients must also be aware of the potential pitfalls. The points below are the potential advantages and disadvantages to consider when it comes to owning income protection through superannuation.

Advantages

- Premiums can be funded from employer contributions, member contributions or by using their existing superannuation fund balance, which may assist clients in managing their cashflow and affordability of premiums.
- Clients can benefit from income tax savings by claiming a tax deduction for personal contributions or by contributing via a salary sacrifice arrangement using pre-tax salary which may provide cost savings on premiums.
- For clients who have cover in an insurance only superannuation fund, they may be entitled to an upfront 15% premium rebate on rollovers made to the fund to pay for their premiums. The 15% rebate represents the tax concession the fund trustee receives from claiming a tax deduction on premiums paid, which is passed back to members.
- The trustee of the superannuation fund will generally withhold PAYG tax on benefit payments before the monthly benefit is paid to the client.

Disadvantages

- In addition to meeting the insurance policy definition of incapacity, the client must also meet the temporary incapacity condition of release under superannuation law before the trustee can pay the income protection benefit to the client (i.e. client must cease employment due to illness or injury to meet the super law condition of release).
- Payments may be delayed as benefits must generally be paid by the insurer to the trustee first.

- Premiums can erode retirement savings if clients don't make extra contributions to negate premium cost.
- Contributions made to fund premiums count towards the contribution caps.
- Additional fees may be payable when funding premiums by way of rollover from another complying superannuation fund.

Income protection outside of superannuation

Owning income protection outside of superannuation can provide clients with more product features and flexibility when compared with owning insurance inside superannuation. Below are some of the main advantages and disadvantages when it comes having a personally owned income protection policy.

Advantages

- Premiums are generally tax deductible for the client if they are both the life insured and the policy owner.
- Can provide protection even if the life insured is not employed at the time of incapacity.
- Policies are customisable and available under different ownership structures (e.g. may be used for business purposes, such as covering business expenses in the event of illness or injury).
- May be able to exchange ongoing payments for a lump sum benefit.

Disadvantages

- If the income protection policy provides for benefits of an income and capital nature, the ATO's view is that only that part of the premium attributable to the income benefit is deductible.[1]
- PAYG tax is generally not withheld from benefit payments, therefore clients may have to budget for ultimate tax liability within that particular income year.

1 https://www.ato.gov.au/individuals/income-and-deductions/deductions-you-can-claim/other-deductions/income-protection-insurance/

Comparison of policies owned inside versus outside of superannuation

The table below provides a summary of the key differences between the three ownership structures.

	Inside superannucation	Outside superannuation	Linked policy
Type of policy	Indemnity	Indemnity[1]	Indemnity[1]
Underwriting	Group policies: assessed for eligibility at the time of claim. Retail policies: underwritten at the time of application.	Underwritten at the time of application.	Underwritten at the time of application.
Waiting periods	Group policies generally have waiting periods of 30 or 60 days. Retail policies can have waiting periods ranging from 14 days to 2 years.	Policies can have waiting periods ranging from 14 days to 2 years.	Policies can have waiting periods ranging from 14 days to 2 years.
Claim	Claim must meet requirements set by the insurer and the trustee of the superannuation fund must determine that a condition of release has been met.	Claim is commenced directly with the insurer.	Claim is first assessed under the superannuation policy and if a condition of release is not met, assessment then occurs under the non-superannuation policy.
Deductibility of premiums	Generally, tax deductible to the superannuation fund. Clients may be eligible to claim a tax deduction for personal contributions or salary sacrifice contributions made to their superannuation fund.	Generally, tax deductible for the portion of the premium attributed to benefits that replace income.	Same as superannuation and non-superannuation policies, e.g. premium generally deductible to the superannuation fund and the client where premium is attributable to benefits that replace income.
PAYG tax withheald from benefit payments	PAYG tax is withheld by the trustee of the superannuation fund before monthly benefit is paid to client.	No PAYG tax is generally withheld when benefit is paid to the policy owner, however payments must be declared on client's annual tax return and taxed at their marginal rate.	Same as superannuation and non-superannuation policies, e.g. PAYG tax withheld on superannuation policy and not withheld on the non-superannuation policy.
Benefit period	Group policies generally have 2 to 5 year benefit periods. Retail policies may provide benefits up to age 65. Some policies may provide to age 70.	Options are generally available from 2 to 5 year benefit periods or to age 65. Some policies may also have to age 70 or more.	Options are generally available from 2 to 5 year benefit periods or to age 65. Some policies may also have to age 70 or more.

1 Agreed value policy available if purchased before 31 March 2020.

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