TPD: INSIDE OR OUTSIDE SUPERANNUATION OR BOTH?

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Suffering a serious accident or injury which results in total and permanent disablement (TPD) can make it difficult to continue to work and earn an income. As an adviser, you play an integral role in helping your clients recognise the importance of TPD insurance and how it can provide a financial safety net which can be used to cover the costs of rehabilitation, debt repayments, the future cost of living and any lifestyle adjustments that may be needed such as wheelchairs, ramps and manual car controls.

But what should your clients consider when deciding on how to structure their TPD cover? When thinking about whether insurance should be held inside or outside of superannuation, it is important to note that there are some key differences between the two structures, such as:

- TPD insurance is restricted to the 'any occupation' definition inside superannuation vs the choice between 'any' or 'own occupation' definitions outside superannuation
- Premiums for TPD insurance are generally tax deductible to a superannuation fund but not to an individual, and
- Upon claim, benefit payments may be subject to taxation if owned inside superannuation.

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. Note, this article addresses TPD insurance for personal purposes and does not address ownership structures for business insurance needs.

Superannuation owned TPD insurance

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 following are advantages and disadvantages to consider when it comes to owning TPD insurance through superannuation.

Advantages

- Premiums can be funded from employer contributions, member contributions or by using an existing superannuation fund balance, which may assist clients in managing their cashflow and affordability of premiums.
- Clients may be able to 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 can 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.
- Premiums may be cheaper in superannuation than outside superannuation, however not always (i.e. structuring TPD via a linked policy can have the same cost as structuring TPD outside superannuation). Thus, an accurate assessment of cost versus benefits, terms and conditions under the policy should be undertaken.
- Fund members may be able to obtain automatic acceptance up to a set level of cover with no medicals required.
- Fund members can generally choose to receive their benefit payments as a lump sum, income stream or a combination of both, noting that in some instances a rollover may be required to access a superannuation income stream.

- If the payment qualifies as a 'disability superannuation benefit[1], part of a client's TPD benefit (including their superannuation balance) may be converted into a tax-free component[2] when a lump sum is paid, or where a client decides to rollover all/part of their TPD benefit to another superannuation fund. This calculation is determined under tax law[3] and recognises a person's permanent disability prior to their assumed retirement age of 65. This tax-free component uplift reduces the proportion of the lump sum that is assessable for income tax purposes. Lump sums paid from superannuation are tax-free for members age 60 or more[4].
- Clients will receive a 15% tax offset on the taxable component of pension payments (to age 60) due to their permanent incapacity. Payments are tax-free from age 60.
- Tax-free investment income and realised capital gains on fund assets supporting the superannuation income stream (i.e. proceeds from the TPD claim that remain in the fund in pension phase are invested in a tax-free environment). Note that the transfer balance cap limits the amount that can be placed into superannuation pension phase.
- Clients can choose to retain the full TPD proceeds inside superannuation and still maintain full access to the capital. This may suit certain clients as investment income and realised capital gains inside superannuation are taxed at 15% (accumulation phase) or tax-free (pension phase) instead of the client's personal marginal tax rate (up to 47%).

Disadvantages

- In addition to meeting the insurance policy definition of incapacity, the client must also meet the permanent incapacity condition of release definition under superannuation law before the trustee can pay the TPD benefit to the client.

  The *Superannuation Industry (Supervision) Regulations 1994* (SIS) defines permanent incapacity to mean ill health (whether physical or mental), where the trustee is reasonably satisfied that the member is unlikely, because of the ill heath, to engage in gainful employment for which the member is reasonably qualified by education, training or experience.

  To be 'reasonably satisfied', a trustee will usually request medical evidence in the form of two doctors' certificates to that effect. This is to also satisfy the requirement for the payment of a disability superannuation benefit.

  The SIS definition of permanent incapacity is generally referred to as an 'any occupation' definition of permanent incapacity because it relates to gainful employment 'for which the member is reasonably qualified by education, training or experience'.

In practice – 'Any occupation' vs 'own occupation' definition

An insurer's Product Disclosure Statement (PDS) and/or the Insurance Contract or Policy will usually state the definition of TPD for insurance purposes. There are two main TPD definitions and insurers will define TPD as either:

1. 'Any occupation' – a benefit will be paid if a person is unable to engage in gainful employment in **any occupation** for which the member is reasonably qualified by education, training or experience. In practice, the likelihood of an insurance payout under this definition is lower than an 'own occupation' definition, but is more compatible with the SIS permanent incapacity condition of release.
2. 'Own occupation' – a benefit will be paid if a person is unable to work again in their **own occupation** they held just prior to TPD. The probability of an insurance payout under this definition is greater than an 'any occupation' definition, but is less compatible with the SIS condition of release.

If TPD insurance is held inside superannuation, it will be the SIS definition of permanent incapacity which must be met to release the proceeds from superannuation. This means if a member has satisfied an 'own occupation' definition of TPD and the insurer pays the insured benefit into the member's superannuation account, the trustee may not be able to pay the benefit to the member if the member does not satisfy the SIS definition of permanent incapacity as it is an 'any occupation' definition. As a result, the insurance proceeds will be trapped in the member's superannuation account until the member is able to meet another condition of release and access the proceeds (i.e. retirement after preservation age).

1 A disability superannuation benefit is a benefit paid to an individual because he or she suffers from ill-health (whether physical or mental) and two legally qualified medical practitioners have certified that, because of the ill-health, it is unlikely that the individual can ever be gainfully employed in a capacity for which he or she is reasonably qualified because of education, experience or training.
2 Conversion is based on a legislated formula and is not automatic. Clients must provide the trustee of the fund with two medical certificates certifying their permanent incapacity prior to cashing out the lump sum or prior to rolling over to another superannuation fund.
3 Calculation defined in s307.145 ITAA 1997.
4 Article assumes the relevant fund is a taxed superannuation fund, i.e. not an unfunded scheme.

For this reason, from 1 July 2014, superannuation funds are prohibited from providing insurance cover to members unless the terms and conditions of the insurance policy align with the death, terminal illness, permanent incapacity or temporary incapacity condition of release. The changes to the SIS Regulations ensure that where members hold insurance policies within superannuation, they are able to access the insurance proceeds from their fund in the event of a claim.

Although any existing pre 1 July 2014 'own occupation' TPD insurance policies are grandfathered, and therefore can remain in superannuation, there is a risk these members may not be able to access their TPD insurance proceeds upon claim time if the member satisfies the insurer's definition but not the permanent incapacity condition of release. To avoid having insurance proceeds trapped within superannuation, advisers of affected clients should consider whether it is possible to restructure ownership so clients can hold the 'own occupation' TPD cover outside the superannuation environment.

Other weaknesses of owning TPD insurance through superannuation include:

- TPD policies that provide additional ancillary lump sum benefits, such as loss of one limb or sight in one eye, without requiring the member to also satisfy the permanent incapacity requirement, are not able to be provided through superannuation.
- Payments may be delayed as benefits must generally be paid by the insurer to the trustee first.
- Although default levels of group cover do not require members to be underwritten (up to automatic acceptance levels) this could lead to complications at claim time (as group policies are assessed for eligibility at the time of claim). To avoid this risk, clients can purchase a retail insurance policy through superannuation (or personally outside of superannuation). While retail cover requires a more detailed application process, underwriting a client's personal history and generally higher premiums than group cover, retail cover can provide clients with better quality cover and greater confidence that a payment is likely to be made at claim time.
- 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.
- Unless members actively opt-in to maintain their insurance, cover may be cancelled if the superannuation fund becomes inactive for 16 months or more, the fund balance falls below $6,000 or the client is under age 25.
- Additional fees may be payable when funding premiums by way of rollover from another complying superannuation fund.
- If insurance is owned in an insurance only superannuation fund, these funds generally cannot pay a disability superannuation income stream. The member would need to request a rollover of the proceeds to another superannuation fund that can pay an income stream.
- If the member requests a lump sum withdrawal or decides to rollover the proceeds to another superannuation fund, the proceeds may be converted into a tax-free component in recognition of the member's permanent disability prior to their assumed retirement age. However, this tax-free uplift is not automatic and must be requested by the member before they make a lump sum withdrawal, commence an income stream or rollover to another superannuation fund.
- Depending on the client's age, tax may be payable on TPD insurance proceeds. Further, the client's 'eligible service date[5]' (ESD) held by the superannuation fund may impact the tax payable on a lump sum TPD benefit.

A TPD lump sum benefit is taxed as a lump sum superannuation benefit as follows:

Age	Taxable component (taxed element)[6]
Under preservation age	22%
Preservation age to 59	0% up to $230,000[7] 17% over $230,000
Age 60 and over	Nil

A disability superannuation benefit income stream will be tax-free if the member is age 60 or over. Otherwise, the taxable component of the income stream payment is assessable at the member's marginal tax rate less a 15% tax offset.

Clients may wish to gross up their level of cover to take into account any tax payable should a benefit payment be made from the superannuation fund.

5 For a detailed explanation on the ESD, refer to http://www.aia.com.au/en/adviser/business-growth-hub/adviser-news/aia-technical-education-centre-of-excellence--tece--tip.html
6 All tax rates include a 2% Medicare levy
7 The low rate cap amount is $230,000 for 2022/23

Potential trap

Funding premiums by rollover may bring across an earlier ESD if an earlier date is held by the source fund. This will increase the 'actual service period' in the fund, thereby reducing the additional tax-free component that may otherwise have been calculated.

Example

Cadence, age 45 (date of birth 4 May 1974) purchased a $1,000,000 TPD policy within an insurance only superannuation fund on 1 July 2015. She has funded her premiums by voluntary contributions so the ESD held within the insurance only fund is 1 July 2015.

On 1 August 2021, Cadence becomes TPD. A tax-free component of $744,747 is calculated[8] on request for a lump sum benefit resulting in $56,156 of tax withheld. Cadence receives a lump sum benefit $943,844.

If Cadence had instead funded her premiums by rollover from her other accumulation/superannuation fund (even if it was only for one premium payment) the ESD from the source fund would have carried over to the insurance only fund.

In addition to her insurance only superannuation fund, Cadence also has another superannuation fund and has been receiving superannuation entitlements since she commenced work on 10 May 1994. If she paid for her premiums by way of rollover, the ESD in the insurance only fund would change to 10 May 1994 which would result in a reduced tax-free component of $394,742. This would result in $133,157 of tax withheld and a lump sum of $866,843 paid.

In this example, Cadence is better off by $77,001 by paying for the premiums by way of voluntary contributions (rather than by way of rollover).

Tip

Besides the 'any' and 'own' occupation TPD definitions, retail insurers also offer other types of TPD definitions, such as 'loss of independence' and 'home duties'.

Generally speaking, loss of independence provides cover if a person is unable to perform at least two activities of daily living, or if a person has cognitive impairment, or has suffered a loss of limbs and/or sight.

Conversely, the 'home duties' definition typically provides cover if a person is unable to perform all five out of five normal domestic duties after a continuous disablement period (usually 3 months). Normal domestic duties specifically include preparing of meals, cleaning the home, performing laundry duties, shopping for household groceries and caring for children (where applicable).

These TPD definitions may also be available within superannuation however an additional clause will usually be included to ensure that the permanent incapacity condition of release is also satisfied.

TPD insurance outside of superannuation

Owning TPD insurance 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 TPD policy.

Advantages

- Access to enhanced TPD definitions that are not available within superannuation, such as the TPD 'own occupation' definition.
- Policies can provide more comprehensive coverage, including ancillary benefits such crisis recovery payments (i.e. trauma), family protection, needlestick injury, etc, (some of which can only be held via a linked benefit).
- 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).
- Can elect for cover to increase in line with inflation to ensure cover keeps up with the rising cost of living.
- No tax payable on TPD insurance proceeds when used for personal purposes (note, covering business needs may result in taxation consequences).

8 Please note that we are using the ATO approach of not double counting denominator service period amounts as per their statement saying "days that are included in both 'service days' and 'days to retirement' are to be counted only once: https://www.ato.gov.au/Super/APRA-regulated-funds/Paying-benefits/Calculating-components-of-a-super-benefit/

Disadvantages

- Premiums are not tax deductible to the client as the benefit is capital in nature.
- Premiums are generally paid with after-tax dollars or may be subject to fringe benefits tax if paid by employer or via salary sacrifice arrangements.
- Pre-existing medical conditions and lifestyle factors such as smoking may impact the cost of premiums (whereas group cover inside superannuation may have automatic acceptance).
- For some professions, clients may not have a choice between 'any' or 'own' definitions due to an increased likelihood of claim. For example, some insurers will limit TPD insurance to 'any occupation' for electricians or rope-access technicians (abseiling).

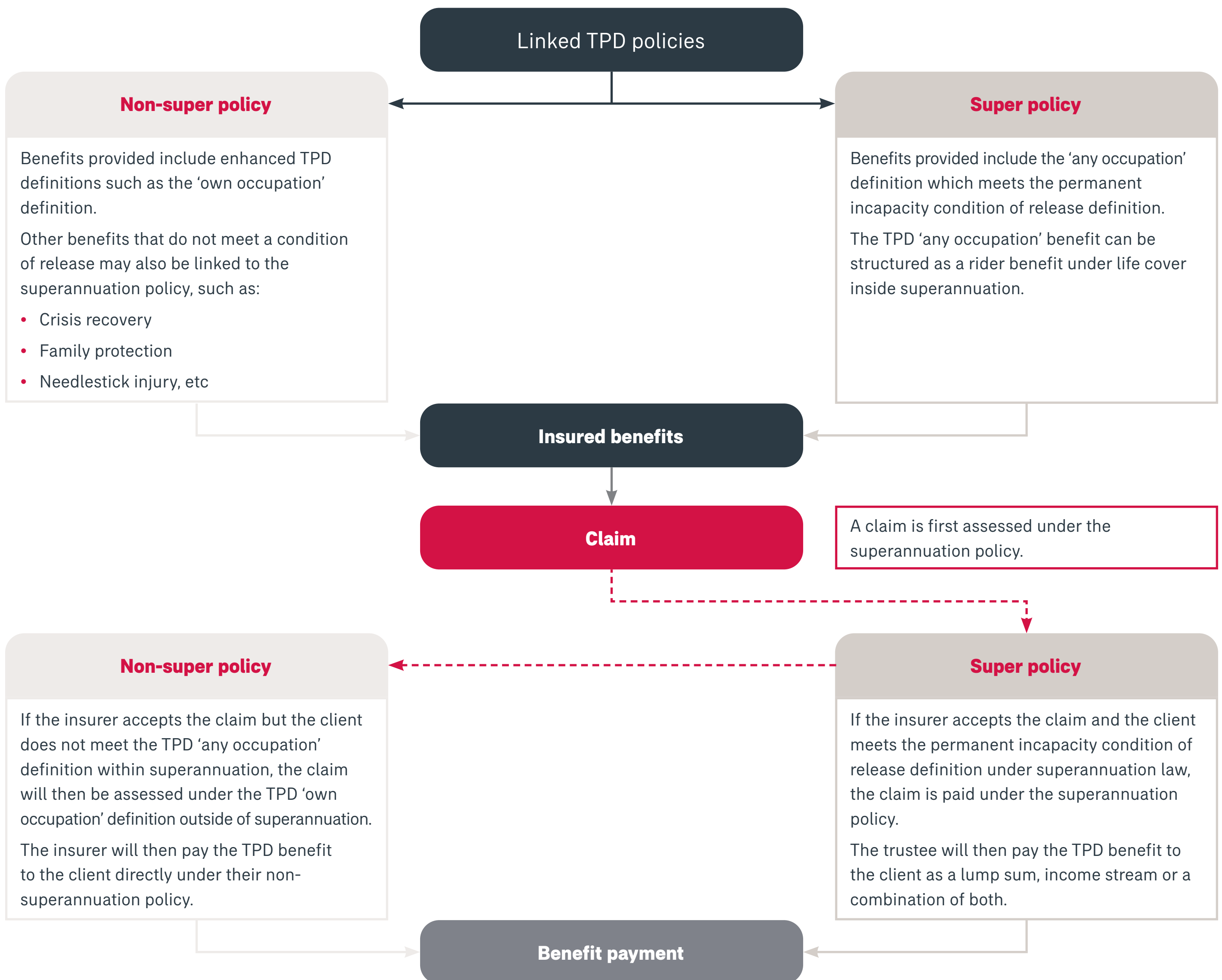
> **Tip**
>
> When it comes to helping clients compare life and TPD insurance cover, it's important to look at both the value of the cover and how much it will cost.
>
> AIA has a helpful tool called "Comparison of insurance premiums funded inside vs outside of super" which compares the value of $1,000 worth of premium and how much it will cost a client when paying with:
>
> - Pre-tax dollars (i.e. by way of salary sacrifice or personal deductible contributions) inside superannuation, versus
> - Paying for premiums personally with after-tax dollars.
>
> This tool can be used as a visual guide to help clients compare the gross cost of premiums at each individual marginal tax rate.

Linked policies

Linked polices are an alternative option for clients who want the best of both ownership structures. Having a linked policy can provide clients with the benefits of owning insurance through superannuation whilst also providing them with enhanced cover and ancillary benefits outside of superannuation.

Two policies are issued where one is owned within superannuation by the trustee of the superannuation fund on behalf of the client and the second policy is personally owned by the client who is the life insured (which will have a separate policy number). Both polices must remain active and if one policy lapses or is cancelled, the linked policy will also be cancelled.

The following diagram summarises how a linked TPD insurance policy may be structured.



When it comes to weighing up the option of having a linked policy, the same pros and cons of having insurance inside versus outside superannuation apply. For example, clients can tailor what cover is inside and outside of superannuation and not compromise their level of cover. This is because a linked policy outside of superannuation gives clients access to enhanced cover and optional benefits that are not available inside superannuation.

However, there are some extra factors that clients should consider when it comes to linked policies, such as:

- The client cannot choose which policy they are paid under upon claim time. If a TPD claim is made, it will firstly be assessed under the superannuation policy.
- The insured TPD benefit amount under both TPD policies must be the same at all times.
- If TPD and crisis recovery are linked to life cover that is owned within superannuation, the TPD and crisis recovery sums insured individually generally cannot exceed the life cover sum insured.

Case study 1

Jill is a 45-year-old who takes out a life insurance policy in superannuation with a life cover sum insured of $2,000,000. Included are a TPD 'any occupation' benefit and a corresponding linked TPD 'own occupation' benefit for $1,000,000 (as a rider not a stand-alone benefit). Jill's superannuation fund is the AIA (Insurance) Superannuation Scheme No2.

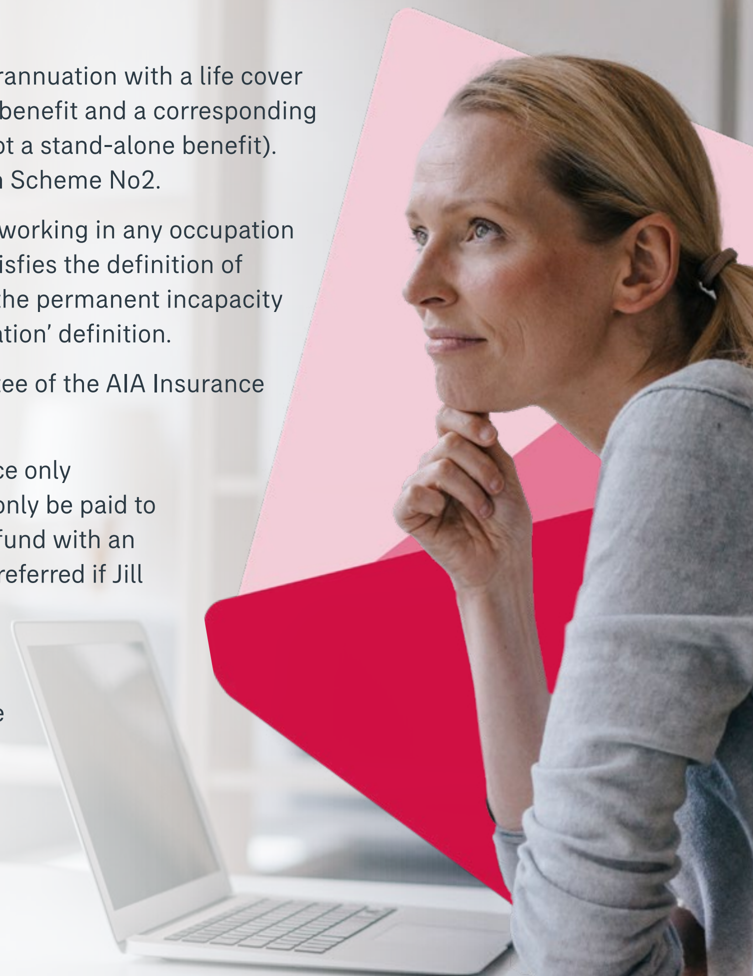
Jill is injured in a serious accident which prevents her from ever working in any occupation that is suited to her education, training or experience. As this satisfies the definition of 'any occupation' and the trustee is satisfied that she also meets the permanent incapacity condition of release, the claim is assessed under the 'any occupation' definition.

AIA Australia pays the insured amount of $1,000,000 to the trustee of the AIA Insurance Superannuation Scheme No2 (the owner of her TPD policy).

As the AIA Insurance Superannuation Scheme No2 is an insurance only superannuation product, the TPD benefits from the Scheme can only be paid to Jill as a cash lump sum or rolled over to another superannuation fund with an investment/accumulation component. The latter option may be preferred if Jill wishes to keep her TPD benefits inside superannuation or if she wants to commence an income stream with all or part of her proceeds. The pension payments could provide day-to-day cash flow for her living expenses as well as being a tax-friendly vehicle for the $1,000,000.

Jill requests to withdraw the entire TPD benefit from her superannuation account to her personal bank account.

Both TPD benefits are cancelled and the life cover in her superannuation is reduced to $1,000,000.



Case study 2

Jack is a 50-year-old surgeon who takes out a life insurance policy within his self-managed superannuation fund with a sum insured of $3,000,000. Included is a TPD 'any occupation' benefit with a corresponding linked TPD 'own occupation' benefit for $2,000,000 (as a rider not a stand-alone benefit). Jack has an accident and loses the use of one arm.

He does not satisfy the definition of 'any occupation' or the permanent incapacity condition of release because he is still able to perform other occupations because of his education, training and experience.

Consequently, the claim is assessed under the 'own occupation' definition of his linked TPD policy. Jack meets the definition of 'own occupation' so his claim of $2,000,000 is paid to him, tax-free.

Both TPD benefits are cancelled and the life cover in superannuation is reduced to $1,000,000.

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 superannuation	**Outside superannuation**	**Linked policy**
Type of policy	'Any' occupation	'Any' and 'own' occupation	'Any' and 'own' occupation
Underwriting	Group policies: assessed for eligibility at the time of claim. Retail policies: underwritten at the time of application and assessed for eligibility at the time of claim.	Underwritten at the time of application and assessed for eligibility at the time of claim.	Underwritten at the time of application and assessed for eligibility at the time of claim.
Waiting periods	Group policies can have a waiting period of up to 6 months. Retail policies generally have a qualifying period of 3 months, however, some policies may waive this depending on the severity of illness or the type of policy purchased (i.e. day 1 TPD).	Generally, have a qualifying period of 3 months; however, some policies may have this waived depending on the severity of illness or the type of policy purchased (i.e. day 1 TPD).	Generally, have a qualifying period of 3 months; however, some policies may have this waived depending on the severity of illness or the type of policy purchased (i.e. day 1 TPD).
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 may make salary sacrifice contributions made to their superannuation fund.	Not tax deductible to the client as benefit is capital in nature.	Same as superannuation and non-superannuation policies, e.g. premium generally deductible to the superannuation fund and not tax deductible to the client.
Form of payment	Depending on the governing rules of the fund, benefits can be paid as a lump sum benefit, income stream or as a combination of both.	Benefit is paid as a lump sum.	Same as superannuation and non-superannuation policies, e.g. if the claim is paid under the superannuation policy, the benefits can be paid as a lump sum, income stream, or a combination of both. Lump sum only if claim is paid outside of superannuation.
Taxation of benefit payments	If client is under age 60, tax is generally payable on TPD lump sums and income stream payments. TPD lump sums and income stream payments are tax-free from age 60.	No tax is payable on a personal (not business purpose) TPD policy owned outside of superannuation.	Same as superannuation and non-superannuation policies, e.g. tax potentially withheld on superannuation policy and not withheld on the non-superannuation policy.

Summary

Making the right ownership structure choice when purchasing TPD insurance will depend on the different requirements of each client. For example, clients who have sufficient cash flow may be better suited to having TPD outside superannuation whereas clients with uncertain cash flows, such as small business owners or young families with tight finances, might be better off holding insurance inside superannuation – noting that clients' situations and needs may change over time.

As this is a complex area for clients to navigate alone, it is important for advisers to explain to their clients the advantages and disadvantages of insurance policy ownership and the benefit of regularly reviewing their insurance needs.

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