TAX TALKS

Australia's Tax News Podcast - The Podcast for Australian Tax Professionals

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180 | Income Protection and Trauma

How does income protection insurance fit in with life, TPD and trauma insurance? What is to cover what?

Income Protection and Trauma

Income protection insurance is to replace your income while you can't work. But of course there is a lot more to it. So we asked Daniel Mikhail of Growth Wealth Partners in Sydney for his insights.

Here is what we learned but please listen in as Daniel Mikhail of Wealth Growth Partners explains all this much better than we ever could.

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TPD

TPD is to kick in when you are unlikely to ever work again. income protection is to kick in when you can't work. So if you qualify for TPD, you would also qualify for income protection. And if you qualify for income protection, you don't necessarily qualify for TPD.

TPD is designed to cover the one off lumpy expenses. So for example repayment of debts, alterations to your house like wheelchair access and the lot. Income protection is to cover your lost income.

75% of Income

An income protection policy can only cover up to 75% of your income or 84.5% of your income including super. You can never insure 100% of your current income.

Some insurers cover 100% of your 9.5% superannuation contributions, taking your cover from 75% to 84.5%.

Link to Income

For life, TPD and trauma insurance there is a review of your income when you take out the policy. But once those policies are signed off aka underwritten, your actual income becomes irrelevant. You could be unemployed or underemployed or changed industry at the time of claim and still be entitled to the full insured amount.

For income protection the link to your actual income is a lot more pronounced. How depends on the type of policy you take out. There are two types of policy – agreed value and indemnity.

1   Agreed Value

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For an agreed value policy you show proof of your current earnings and then that topic is ticked off. The insurer won't ask about your earnings again.

You can't have an agreed value inside of super. An agreed value policy always has to sit outside of super.

2 Indemnity

For indemnity you just advise what you earn but nobody checks right now whether you actually earn this. You get your policy for the income you told them. However, at claim time you need to demonstrate that you are actually earning the income that you said you earned at the time of application.

And if your income for any reason does not stack up at the time of claim then you will only receive a payout for that actual income. So you would have paid premiums for a higher income than you actually get.

And this is where a lot of people get caught out. It tends to especially affect the self-employed since their income can fluctuate a lot more than that of employees If you have a few poor years leading up to the date of claim, then you get less than you paid for.

Super

Inside of super you can only have indemnity. Outside of super you can have agreed value or indemnity.

For an indemnity policy inside of super only the last 12 months of income count. But outside of super they take the best year of the last 2 or 3 years. So outside of super you have a wider window to get the full value of your indemnity contract.

For an agreed value contract this does not come into play, since an agreed value contract is based on what you locked in at the time you applied for the cover.

Unemployed

If you are unemployed at the time of claim, an agreed value will still pay you the agreed value. For an indemnity policy it gets tricky though.

If you have the indemnity policy outside of super, hopefully you had some work over the two or three years before the claim. And then you can still pick the good year you had work.

But for an indemnity policy inside of super you don't receive a cent if you are unemployed at the time of claim. You could have worked until the day before the accident. If you are unemployed on the day of the accident, then you don't receive anything. You got to be gainfully employed at the time of claim. A lot of people get caught out in that.

Tax Deduction

You can claim a tax deduction for income protection premiums inside and outside of super. So it usually makes sense to hold income protection outside of super whenever your marginal tax rate outside of super is more than 15%.

However, if cash flow is an issue and there is enough super to fund it through super, then it can make sense to hold income protection within super.

But don't have it in super indefinitely. Have a plan to get it out of super at some point because you don't want to erode your retirement savings in premiums. So have a plan in place at some point to get in out of super into your personal name.

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Assessable Income

When you receive a benefit under your income protection policy, that payment counts as assessable income just like the salary or wage did you are replacing.

Trauma/Critical Illness

Trauma insurance often serves three purposes.

1 – Trauma is to plug the 25% gap between your income protection policy and your actual income.

2 – Trauma is to give you the means to cover large medical expenses associated with trauma events. It is to allow you to cover your private expenses for specialists or enable you to go overseas for specialist treatments.

3 – Trauma insurance is to allow your spouse to take time off from work to care for you.

Which of these you need to cover depends on your individual circumstances.

Trauma is like life and TPD in that it is not linked to actual income. Once there is agreement on the insured value, it does not matter what you are actually earning.

There is no tax deduction for trauma insurance premiums. And so any payments to you are not assessable income either.

Trauma insurance must always be held outside of super. You can't hold trauma inside of super.

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