TAX TALKS

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40 | Personal Insurance Inside or Outside of Super

Personal insurance inside or outside of Super – that is the question. If we get this wrong, our client might be paying for insurance they might not qualify for in the end.

Personal Insurance Inside or Outside of Super

When should our clients hold personal insurance inside or outside of super? This is the question we asked Daniel Mikhail of Partners Wealth Group in Sydney.

Here are some of our notes summarising what we learned. But please listen to this episode of Tax Talks since Daniel explains all this much better than we ever could.

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Types of Policies

Personal insurance usually covers 4 types of policies. Life – Income Protection (IP) – Total and Permanent Disability (TPD) – as well as Trauma, also called Serious Illness.

Budget Implications

The 2016-17 federal budget resulted in some of the biggest changes in super since the introduction of the Simplified Superannuation System (SSR) in 2007. These comprehensive changes have widespread implications for insurance advice.

Actuarial consulting firm Rice Warner estimates that in Australia 71% of death cover, 88% of all TPD and 59% of all IP cover is provided through super.

Here is a list of the changes that will impact how to optimise personal insurance inside or outside of super.

1 Concessional contributions

From 1 July 2017 the concessional cap is $25,000, down from previously $35,000 and $30,000. The tax treatment of concessional contributions in excess of these caps hasn't changed so will continue as is.

Insurance implications

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The lower caps will restrict the funding of insurance premiums. Making excess concessional contributions may still be an option though.

2 Deducting personal contributions

Before 1 July 2017 a client had to earn less than 10% of their income from employment activities to claim a tax deduction for a personal contribution to super. This rule is broadly known as the 10% rule or the substantially self employed rule. This was and is a popular strategy for self-employed clients since they can tax-deduct their concessional contributions.

Others had to use salary sacrifice arrangements to get the benefit of the deduction in the past.

From July 1, 2017, the 10% rule no longer applies. This means that employed individuals can now claim a tax deduction for personal contributions. The concessional cap of $25,000 applies.

Insurance implications

Funding insurance premiums through accumulation balances resulted in super erosion. Clients can now offset this erosion by contributing an amount to super equal to their premium (within the cap of $25k). This is an area where many clients will need help.

It is important to comply with the notice formalities to ensure the client gets a tax deduction for their contribution. Clients must complete an s 290 170 notice of intent to claim a deduction. Make sure the notice meets the legal requirements and is valid .

3 Unused concessional cap carry forward

Clients can now carry forward their unused concessional contributions (within the concessional cap) for up to 5 previous years. This option is only available where the member’s TSB is less than $500,000 in the year of the “catch up”. This option is available from 1 July 2018.

Insurance implications

This will especially benefit clients with irregular income patterns. They will be able to ‘catch up’ on unused portions of the cap and offset multiple years of superannuation erosion. This is a handy SOA solution for mitigating erosion over the medium to long term.

4 Transfer balance cap

With effect from July 1, 2017, amounts in the tax exempt pension phase are subject to a cap of $1.6 million per member. Amounts in excess of this amount must remain in accumulation phase or move out of the superannuation system altogether.

Insurance implications

Having an insurance policy in excess of the cap does not breach the cap. The cap only applies to balances that are in pension phase.

The TBC will impact the way clients distribute the proceeds of their accumulated balance plus insurance to beneficiaries.

Benefits paid in lump sum form to beneficiaries will not impact the deceased, nor the beneficiaries cap.

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However, benefits paid as a pension will impact the beneficiaries, although the impact is different for tax dependants (e.g spouse and children).

The value of the asset supporting the death benefit pension to tax dependants such as a spouse, will be assessed against their transfer balance cap.

If the pension recipient does not have a transfer balance account (TBA) yet, then the general transfer balance cap (currently $1.6 million) applies. The value will effectively start a transfer balance account for the beneficiary as the asset is in pension phase.

5 Income protection ancillary benefits

Many income protection policies contain a mixture of revenue and capital ancillary benefits. There is a need to consider how these benefits might treated from a tax perspective. In a competitive market, policy holders are receiving more and more ancillary benefits.

The two main ancillary benefits paid under an IP policy are the scheduled injury benefit and the critical conditions benefit.

Insurance implications

Product Ruling PR 2016/6 confirms the treatment of the critical conditions benefit as being capital in nature.

It also concludes that the scheduled injury benefit is compensation for loss of capacity and is therefore capital.

The Product Ruling is contrary to well established industry practice of treating the benefit as revenue in nature.

There is no in-depth analysis of the basis of conclusion.

Advisers should consider the nature of the benefit before making a determination on how to tax the benefit.

6 Other federal budget bits and pieces

Anti-detriment benefits no longer exist from July 1, 2017.

The transfer balance cap also applies to TPD pensions.

Work tests will still apply for those aged between 65-75 with the requirement of 40 hours employment in a 30 day period.

Trustees can now rollover a death benefit to complying super in order to pay a death benefit pension. This has come in with effect from 1 July 2017.

7 Regulation 4.07D

Regulation 4.07D commenced July 1, 2014

This regulation prohibits insurance in super for benefits that are inconsistent with a condition of release.

Policies in force prior to July 1, 2014 are grandfathered.

Trauma, own occupation TPD and IP have been affected. IP policies have been most impacted with many ancillary benefits now restricted inside super. Two examples are specified injury benefits or critical conditions benefits. But there are many more ancillary benefits that are no longer available.

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Advisers must consider the impact of grandfathered policies and new IP superannuation policies.

Insurance implications

Advisers need to consider the impact of regulation 4.07D grandfathered policies.

Clients that retain grandfathered income protection products may have part of their benefit retained in superannuation.

Is the SuperLink approach more beneficial for these clients? Can they alter their contract to SuperLink (underwriting concers?).

Don't let a grandfathered policy lapse – the insurer will be unable to re-instate due to 4.07D.

Regulation 4.07D provides a great opportunity to contact existing clients for a review of their insurance needs and objectives.

8 Limitations of IP through super

Agreed value has a cap in super due to SIS cashing restriction.

The time period for pre-disability earnings through super is less generous. Inside super it is only 12 months, whereas outside of super 2 or often 3 years.

For partial disability the insured must have ceased work for some period of time.

If unemployed at time of disability, the insured must have ceased work due to sickness or injury. In cases where clients were unemployed prior to disability they will not qualify.

When sickness or injury results in 'permanent incapacity', SIS Rules prohibit benefit payments where the insured is 'permanently incapacitated'.

SIS cashing restrictions may mean in some cases that increasing claims option (ICO) will not apply.

Since many benefits do not satisfy the SIS conditions of release, they are no longer available through Super.

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