Did you know?

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Pros and Cons of income protection (IP) in super

Advisers are aware of the advantages of holding risk insurances, including IP, inside superannuation. However, the pitfalls of doing so may outweigh the advantages; even more so following recent superannuation legislative changes.

The Stronger Super changes effective 1 July 2014 prohibit super funds from offering risk insurance policies that are not aligned with the SIS conditions of release. The relevant condition of release for IP in super is generally temporary incapacity.

No additional tax benefits

Unlike term life and total and permanent disability (TPD) insurances, there are no additional tax benefits in funding IP premiums by making salary sacrifice or personal deductible contributions to super. In fact, the tax deduction to the individual is lost, unless he or she is eligible to make personal deductible contributions to super. Clients with IP outside super can claim a personal tax deduction for the premiums, or a benevolent employer can pay for an employee's self-owned IP policy and claim the tax deduction, with no impact on the employee's cash flow. Unlike term life and TPD insurances, there is no FBT liability for the employer in this situation under the otherwise deductible rule. Benefits are generally taxed in the hands of the beneficial owner (that is, the member if policy is held through super, or the insured if held outside super) at their own marginal tax rate.

Gainful employment

If a member is not in gainful employment at the time of disability, the trustee cannot pay a temporary incapacity (i.e. IP) benefit to that member. This will impact members who are unemployed at the time of disablement or between contracts of employment, as well as those members who are on unpaid leave from their employer.

Pre-disability income

A temporary incapacity condition of release requires that only income earned immediately prior to a disability (pre-disability income) is taken into account when paying an income protection benefit inside super, which may leave some benefits trapped in super. Here's a case study to support this point:

> ***Case Study***
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> Consider this scenario, based on an actual situation: A super fund member was self-employed and had structured his business to operate via a family trust. The member became totally and temporarily disabled under his agreed value insurance policy and accordingly, the insurer admitted an income protection benefit under the policy, and the benefit was paid to the trustee as owner of the policy.
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> The business was run through a family trust, and the member did not earn any personal income in the previous 12 months (his personal income tax return showed a taxable income of $0.00). As a result, the trustee was unable to pay the benefit to the member on temporary incapacity grounds, as the trustee cannot pay more than 100% of the member's pre-disability income, which in this case was zero. The trustee had no option but to roll over the benefit to another complying superannuation fund, to be retained in the superannuation environment until a condition is met. This situation occurred with a client who had a pre-July 2014 grandfathered agreed value IP policy with a substantiated monthly benefit of $3,114. Had the policy been effected under the new Stronger Super regime, there would have been no benefit at all to roll over. However, if the member had an agreed value Income Care (or Plus) policy with CommInsure, he would have been paid the full $3,114 monthly benefit upon confirmation of total and temporary disablement, even if he were unemployed at the time of the event.

Advantages of IP in super:

- Cash flow: Cash strapped clients can have the premiums deducted or rolled over from their super account balance without having to make additional after-tax contributions or can have premiums paid via employer contributions.
- Renewal reward: some providers, such as CommInsure, provide a reward (discount) of up to 15% on renewal of Total Care Plan Super policies
- Certain providers, such as CommInsure, offer a modified agreed value as well as indemnity version of IP in super
- Possible automatic acceptance if IP is taken through an industry or employer-sponsored super fund, and premiums may be more competitive
- May qualify for government co-contribution if premium is funded by after-tax contributions
- Ability to make spouse contributions to fund premiums.

Advantages of non-super IP policies

- Ability to have a fully featured income protection product, with ancillary benefits such as crisis and specific injury benefits, Permanent Disablement Cover options, etc.
- Generally no cap on employer benefits, such as sick leave, annual leave and long service leave
- No cap on level of increasing claim benefit (5% maximum inside super)
- No restrictions on benefit payments if insured client is unemployed, on unpaid leave, or if pre-disability income has decreased to the point where trustee has to pay a reduced benefit inside super
- Ability for insured or employer to pay premiums and claim tax deduction
- Avoids negative impact on concessional contribution caps and does not impact on retirement savings
- IP claim is not subject to super fund's trust deed terms, including whereby a temporary incapacity benefit payment may cease unless benefit can be paid as a permanent incapacity income stream.

Which option for your client?

This would partly depend on your client's circumstances: for instance, cash flow may be an overriding issue, so having some cover would be better than having none. However, other external circumstances, over which your client has no control, may prevent a temporary incapacity payment due to superannuation legislative provisions. This generally would mean that your client is taking on greater risk with an IP policy inside rather than outside super. If the client is willing to take this risk, it is incumbent on the adviser to provide the appropriate warnings and explanations.

Summary

Income protection in super is becoming increasingly popular, and for understandable reasons. However, there are a number of pitfalls inherent in having this product governed by superannuation legislations. Clients should be made aware of the rules and pitfalls on the occurrence of certain events, such as unemployment, so that they can make an informed decision about whether to apply for IP inside or outside super.