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TechKnowledge

SMSF and Insurance

Some types of income protection insurance not allowed within superannuation

Trustees of SMSFs are required to regularly review their investment strategy and to consider insurance for the members as part of that review.

Up until 1 July 2014 any type of life insurance could be held through superannuation, however from this date SIS regulation 4.07d will prevent trustees from offering insurance where the insured event doesn't align with the conditions of release. In effect, this means that new 'own' occupation TPD cover, trauma insurance and some types of income protection will no longer be able to be taken out within superannuation.

This will be the case even where the insured would be able to access the funds under another condition of release. For example, someone over 55 may not have an issue holding trauma insurance within superannuation if they felt they would permanently retire if they suffered an event insured under that policy.

This change will not affect individuals who on 1 July 2014 hold a policy which doesn't satisfy the new requirements as they will be able to continue being covered under their existing policy.

Advantages and Disadvantages of Insurance in SMSF's

Term Life and TPD is usually held to not only meet lump sum costs such as paying off the mortgage but also to replace lost income. Superannuation is arguably the most suitable environment to facilitate an income stream and it is here that there are significant differences.

Where the Term Life insurance is paid through superannuation and the proceeds are to be paid to a dependant such as a spouse or minor child, the dependant may be able to take a portion of those benefits as an income stream.

In addition, where an individual successfully claims on a TPD policy, they will generally satisfy the permanent incapacity condition of release and the insured would be able to commence an income stream.

The payments from both these types of income streams would be concessionally taxed and would be tax-free where the recipient is 60 or over or in the case of a death benefit income stream, if the deceased was 60 or over.

Further, the earnings within the fund would be tax-free and the benefits would remain unrestricted non-preserved meaning that lump sum payments could be withdrawn at any time though they may be subject to tax. Further, if the income stream was subsequently rolled back to accumulation and the recipient was not yet of Age Pension age, the benefits would not be assessed for the Centrelink income or assets tests.

We can contrast this to the situation where the insurance is held outside and therefore the proceeds will be held directly by the beneficiary where the earnings on those proceeds will be taxed at the beneficiary's marginal tax rate. However lump sums can be taken and used at anytime tax-free.

If the beneficiaries wished to contribute these funds into superannuation, the benefits would be preserved and the beneficiary would need to satisfy a condition of release. While the recipient of a TPD payout would likely satisfy the permanent incapacity condition of release, the beneficiary of a life insurance policy may have to wait until they can start a transition to retirement pension. In the event they could access the funds, a benefit of this strategy is that all the benefits would form part of the tax-free component and any pension payments and/or withdrawals would be tax-free.

Taxation

There are taxation benefits to holding insurance within superannuation which is obviously an important consideration to whether holding insurance inside our outside super is more appropriate. However, taxation considerations should be secondary to ensuring the client has the level and type of cover they desire and that the product aligns with their requirements.

Premiums

A major benefit of holding Term Life and/or TPD within superannuation is that the premiums are tax deductible whereas if held outside they are not. The allowable deductions are as follows:

Insurance	**Allow deduction** (% of premium)
Life	100%
TPD – any occupation	100%
TPD – own occupation	80%
Not a single member fund	67%

The greatest benefit from the deduction on life insurance is derived where the individual can fund premiums with concessional contributions and the individual isn't liable for the contributions surcharge (Division 293 tax). In this case, $1,000 of premium can be paid from $1,000 of pre-tax salary.

Proceeds from Insurance

The taxation of superannuation lump sums including insurance proceeds is complex, however it is important to note insurance proceeds are added to the taxable income of the fund.

There is a concession for individuals making a lump sum withdrawal due to permanent incapacity which involves increasing the tax-free component of the benefit based on the number of years to retirement. For the remainder of the payment which will be subject to tax, it is worth considering grossing up the amount of TPD payout which is to be taken as a lump sum to account for this tax.

Term Life is usually held for the benefit of individuals who would be considered 'death benefit dependants' of the deceased and therefore, would receive the insurance proceeds tax-free as they would if the insurance was obtained outside.

However, where the beneficiary is a non-dependant there can be significant tax consequences due to the creation of an untaxed element which is taxed at up to 32%. The remainder of the taxable component is taxed at up to 17%. Where the benefit is likely to be paid to a non-dependant, consideration should be given to grossing up the cover.

Insurance Strategies in SMSFs

SIS regulation 4.07D came into effect on 1 July 2014 and states that a superannuation fund trustee 'must not provide an insured benefit in relation to a member of the fund unless the insured event is consistent with' one of the following conditions of release:

- Death
- Terminal medical condition
- Permanent Incapacity, or
- Temporary incapacity.

There is an exemption for policies that were in place as at 1 July 2014.

There is some uncertainty regarding the interpretation of this regulation, but the ATO's initial view is that 'The Explanatory Memorandum associated with the amended regulations makes it clear that the proceeds of an insurance policy must be released to the member who is the insured under the policy.'

2 classes of strategies to be concerned about

Based on this view, new policies cannot be taken out to effect a cross insurance and it would appear that the pooled earnings strategy is also no longer allowed. As such, where a new policy is taken out, the premiums would need to be deducted from the insured member's balance and the proceeds paid into that member's account. Any other strategies using insurance are no longer allowed to be put in place.

However, it is important to note that the regulation only applies to new policies and therefore, there are many arrangements in place which will continue. The adviser will need to ensure that the policy they intend to replace is not supporting one of these strategies as once the supporting policy is cancelled, the arrangement will also cease and cannot be reinstated. There are 2 classes of strategies to be concerned about.

Cross-Insurance

Cross insurance is a strategy to provide liquidity to a fund where the insured's balance is to be paid out of the fund in the event of death or disability and there is insufficient liquid assets in the fund to accommodate this.

An important concept relating to cross insurance is it is consistent with the requirement for trustee's to allocate fund monies on a 'fair and reasonable basis' where they pay the proceeds from an insurance policy into the member's account from which the premiums were deducted irrespective of who the life insured was. Therefore, we can deduct the premium for the pre 1 July 2014 insurance policy on the life of Member A from Member B's account and on the death of Member A, the insurance proceeds would form part of Member B's balance.

A situation where liquidity insurance would be implemented in this manner is where business partners hold their premises in an SMSF as shown below.

Greg and James run a retail furniture store together and own the shop worth $1 million in an SMSF. They are the only members and have benefits of $500,000 each. On the death of one, the survivor would like to be able to pay out the death benefit but retain the shop in the fund.

To facilitate this, the SMSF took out a pre 1 July 2014 policy for $500,000 on each of their lives with the premiums for the policy on James' life being paid from Greg's account and vice versa. James dies and the proceeds of the insurance policy are paid into the SMSF's bank account increasing Greg's balance to $1 million.

James' death benefit is paid out using the funds in the SMSF's bank account and ultimately, Greg will be the only member of the fund and the sole asset will the $1 million property.

In a 'mum and dad' fund, the members will likely be the beneficiaries of each other's death benefits and therefore, any insurance for liquidity purposes could be 'self-insured' with the proceeds forming part of the deceased's benefits. The surviving spouse could then use those proceeds to fund a death benefit to themselves, leaving the deceased's pre-insurance benefits in the fund.

Pooled earnings

A pooled earnings strategy is also used to address liquidity issues but in this case the premiums are deducted from the pooled earnings of the fund before allocation those earnings are allocated to member's accounts. On the subsequent receipt of the proceeds the trustee deals with them based on the rules of the trust deed or on their own discretion if the deed gives them the power to do so.

Even before the introduction of the regulation 4.07D, there were a number of concerns with this strategy particularly around the tax treatment of the proceeds.

During an industry consultation (NTLG Superannuation subcommittee June 2012) the following scenario (along with 2 others) was put to the ATO for them to clarify the tax situation.

Scenario 1

- The governing rules of the fund contain specific clauses defining a member's death benefit only to include some of the insurance proceeds,
- the balance of the insurance proceeds received by the fund are retained by the fund and immediately credited to the member balances of surviving members on a fair and reasonable basis, and
- the insurance premiums have been deducted from the pooled earnings of the fund as a general fund expense (ie prior to allocating fund earnings for a particular year to member accounts)?

The ATO representatives at the meeting declined to do so stating that there was insufficient information to determine whether the situation above would result in a reserve. If it did, the allocations would likely be assessed as concessional contributions for the members receiving distributions from the reserve. These distributions would be subject to the concessional contributions cap.

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