

# Macquarie Life

## The ins and outs of insuring through super

**Macquarie Adviser Services**



**FORWARD** thinking

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# In or out of super – the issues

Deciding whether client insurance arrangements should be held inside or outside of super involves assessing the tax, benefit access and social security implications of each alternative.

While there are important other considerations in determining the most appropriate insurance arrangements for your clients, this booklet provides a brief analysis focusing on tax and access issues. In particular, it takes account of the numerous tax law developments in recent years which have affected the tax appeal of insuring via super.

The aim is to identify some rules of thumb as to the circumstances in which super or non-super arrangements may best suit particular categories of clients.

## How to use this booklet

This booklet is divided into the following sections, in line with the common types of traditional insurance cover:

1. Life
2. Total and Permanent Disablement
3. Disability Income Insurance
4. Trauma.

Each section of the booklet contains a general comparison of the tax efficiency of three different ways of funding the insurance; ie by the client opting for:

- 1. non-super:** paying for the insurance with after-tax income and holding the policy in their own name
- 2. super CCs:** arranging for a concessional contribution (CC) to be made to a super fund and for the fund trustee to pay the premium and hold the policy in its name
- 3. super NCCs:** making a non-concessional contribution (NCC) to a super fund and for the fund trustee to pay the premium and hold the policy in its name.

It also contains a discussion on the extent to which benefits funded by the particular type of cover are readily accessible to the client under a super arrangement, and whether there are other issues to consider relating to super law.

While the focus here is on traditional types of insurance, some aspects of the analysis are relevant to a new type of life insurance cover now available in Australia which combines a number of traditional types of life insurance a client may need. We discuss this briefly on page 36.

A glossary of key definitions and legislative terms is also included at the end. We have not included social security considerations in our analysis, but as a broad proposition, the means testing of insured benefits provided via super tends to be at least as beneficial as the means testing of the equivalent non-super insured benefits.

## Other references for particular client scenarios

After reading this booklet you may be interested in modelling your clients' specific scenarios. To assist you with this, the Macquarie Life insurance tax calculator is provided on the Macquarie Life website. The calculator allows you to:

- gross up the amounts of life and TPD insurance required inside super to account for tax on insured super benefit
- compare the pre-tax cost of insurance inside and outside super.

## Background on tax comparisons

### Super CCs and the CC cap

CCs are generally contributions made by a client's employer or personal contributions which the client claims as a tax deduction. These contributions are 'pre-tax' for the client and are taxed at 15 per cent within the super fund. A \$25,000 annual cap (\$50,000 for those 50 and over) applies to these types of contributions in the 2011/12 financial year.

If a client is currently using up their CC cap fully before taking insurance into account, any funding of insurance through super will effectively need to come from NCC contributions (assuming they don't decide to use some of those existing CCs or their accumulation balance to fund the insurance premiums).

### Super NCCs and the NCC cap

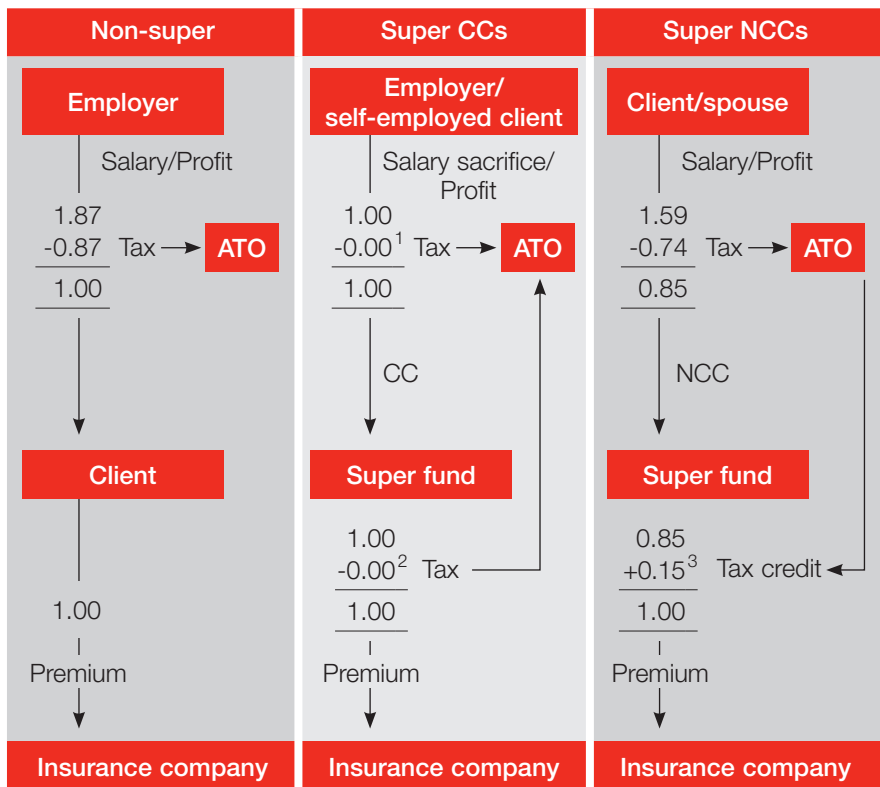
NCCs are usually personal or spouse contributions which the contributor cannot claim as a tax deduction. A \$150,000 annual cap applies to NCCs made in the 2011/12 financial year. A 'bring forward' rule allows a client under age 65 to bring forward up to two years of entitlements to make NCCs of up to \$450,000 over three years.

**Example: Pre-tax cost of \$1 of life cover premium – 46.5 per cent marginal tax rate**

The following example illustrates the pre-tax cost of paying for \$1 of premium using the three different funding options outlined earlier:

1. non-super
2. super CCs
3. super NCCs.

**Diagram 1**



Insurance proceeds from policies held inside super may be taxable when paid out of the fund in certain cases (eg death benefits paid to non-dependants and some TPD benefits).

<sup>1</sup> Nil tax payable as deduction for CC offsets tax liability on salary/profits.

<sup>2</sup> Nil tax payable as deduction for premium offsets tax liability on CC, assuming the premium is fully tax deductible.

<sup>3</sup> Value of tax deduction for \$1 premium payment, assuming the premium is fully tax deductible.

## Some general assumptions

Here are some general assumptions we are making in relation to the calculations, examples and comments made throughout this booklet:

- all references to a super arrangement assume that the fund is a complying super fund and is a taxed super fund, not an exempt fund such as certain public sector schemes
- all super contributions are within the relevant annual cap for tax purposes
- the benefit of all super fund deductions for premium payments is credited to the client's super account. This will be common if the client has an accumulation account within the fund or if the contributions funding the premiums are CCs. It will not be common where NCCs are made to a super fund as a stand-alone insurance arrangement
- no tax liability arises for a super fund trustee on insurance proceeds it receives under the policy
- no Government co-contributions have been accounted for
- no anti-detriment benefits have been accounted for. (These are typically not generated in relation to insured benefits)
- super law refers to the *Superannuation Industry (Supervision) Act 1993* and regulations made under it
- in the examples where insurance is being funded inside super using NCCs, for simplicity, we have disregarded the effect of any tax free component arising from the contributions used to fund the premiums. In practice, the benefit paid out may include a small amount of tax free component, the extent of which will depend on the total amount of NCCs (less withdrawals etc) made to the account from which the benefit is paid
- the level of gross premium payable to the life office (either by the individual directly, or by the superannuation fund) is the same in each case – in practice the availability of group life arrangements and pricing differences generally may mean this is not the case
- timing issues (such as receipt of tax benefits) are ignored
- the impact of stamp duty has not been considered
- a temporary 'Flood reconstruction levy' is payable by some taxpayers in the 2011/12 year only. The analysis does not take into account the effect of the levy on benefit payments
- BF Tax is the effective benefits tax that is payable on superannuation lump sums
- SF tax refers to the super fund tax rate of 15 per cent.

# Life cover

## Tax efficiency comparison

The starting point for this analysis is a table showing the pre-tax cost of life insurance per \$1 of premium where the ultimate beneficiary is a *dependant* of the insured client for tax purposes.

What we mean by pre-tax cost is the amount of a client's gross remuneration package that would be needed to pay the premium. The table shows this pre-tax cost (rounded to two decimal places) for each \$1 of premium.

**Table 1**

Pre-tax cost for each \$1 of premium			
Client's Marginal Tax Rate	Non-Super	Super CC	Super NCC
31.5%	\$1.46	\$1	\$1.24
38.5%	\$1.63		\$1.38
46.5%	\$1.87		\$1.59

## Key additional assumptions

The following assumptions are made in addition to those set out on page 4.

### Premium deductibility

Under the non-super option the premiums are not deductible whereas under the super options the premiums are fully deductible to the fund trustee.

### Benefits not subject to tax

The benefit arising from the insurance will not be subject to income tax. That is, in the case of super, it will be paid as a lump sum to a member suffering from a *terminal medical condition* or someone who is a *dependant* of the member for tax purposes (either directly or via the deceased's estate) – see page 7 for comments on benefits provided to non-dependants for tax purposes.

## Access to benefits

### **Super benefits immediately accessible to qualifying beneficiary**

There are no constraints on accessing super benefits in the event of a client's death or where a client is suffering from a *terminal medical condition*. Indeed, benefits are required to be paid (or, in the case of a pension, to start being paid) as soon as practicable following a client's death. The range of beneficiaries of a death benefit is generally limited to the client's estate or *dependants* (and is subject to the fund's governing rules).

### **Non-super benefits**

Access to non-super insurance proceeds is generally a straightforward matter of payment to the policy owner or their estate unless there is a nominated beneficiary, in which case payment is to the nominated beneficiary. A nominated beneficiary is not required to be a *dependant*.

# Rules of thumb

Based on the assumptions outlined, we have distilled the following rules of thumb.

## Benefits paid to tax dependants – super wins

**It can be seen from Table 1 on page 5 that it is significantly more efficient to provide an insured lump sum death benefit via superannuation if the beneficiary is a *dependant* for tax purposes. This is particularly the case where the premiums are funded with CCs, but still applies for NCCs.**

In the case of spouse and minor (and certain disabled) child *dependants*, the option of receiving a super benefit in pension form may also be available. In many cases (even where some tax is payable on the income) pension benefits can prove to be even more tax efficient in the long term.

## Benefits paid to tax non-dependants

If the purpose of the insurance is to provide a non-dependant with a benefit in the event of the client's death, then the arrangements can rank in the following order for tax efficiency:

1. super CCs – inside super where the premiums are funded with CCs
2. outside of super
3. super NCCs – inside super and funded with NCCs.

This top ranking of super CC arrangements always applies where the non-dependent beneficiary will not be receiving any accumulated (non-insured) taxable benefit from the super fund which is effecting the insurance.

### Insurance in the same fund as accumulating super benefits?

To the extent that super benefits are to be paid to a non-dependant, establishing life cover in the same fund as a client's accumulating super balance can have the effect of increasing the tax on the accumulating benefit. However, the tax effect may still be favourable compared to holding the cover in a separate fund, depending on the client's *service period*. This is because the longer the client's *service period* in the fund holding the insurance, the lower the effective tax rate on the overall benefit. So there is no general rule of thumb about whether or not it is tax efficient for life cover to be held separately from accumulating benefits.

## Macquarie Life insurance tax calculator

The Macquarie Life insurance tax calculator provided on the Macquarie Life website can be used for specific tax calculations for particular super arrangements. Also refer to the appendix for specific tax calculation rules for super lump sum benefits paid to non-dependants.

## Looking after dependants and non-dependants

As a general proposition, lump sum death benefits paid from taxed super funds to *dependants* are tax free whereas they are typically subject to tax if paid to non-dependants. It is therefore worth exploring the extent to which a client's estate plan can provide only for *dependants* from super (including insured and accumulated benefits) and provide for non-dependants from non-super assets.

### **An exception – non-insured tax free super benefits**

One exception is where the client accumulates a non-insured benefit which substantially comprises tax free component. As the tax free component is not taxed in the hands of a non-dependant, this can be an efficient way of providing for a non-dependent beneficiary via super.

## Life cover examples

### Example 1 – Life cover through super paid to dependants

Robert is 35 years old, he is on a marginal tax rate of 31.5 per cent and wants insurance cover to provide for his two children Susan and Tom (both minors) in the event of his death. Robert's adviser has determined that he needs \$500,000 of life insurance. Let's assume the premium is \$385.

#### What is the pre-tax cost of this cover if Robert funds it:

1. inside super using CCs
2. inside super using NCCs or
3. outside super?

Robert is better off using super and funding the premiums via CCs, followed by super with NCCs and then non-super. The Macquarie Life insurance tax calculator can assist with calculations but the following is a description of the key calculations.

#### 1. The pre-tax cost of the premium inside super using CCs is \$385.

When funding insurance using CCs, any tax liability on the assessable income of the contributor is offset by a tax deduction on the CCs. The CCs are assessable income in the hands of the fund but that in turn is offset by a tax deduction on the insurance premium. As a result the pre-tax cost will always be equal to the premium. Refer to Diagram 1 on page 3 and Table 1 on page 5 for further guidance.

#### 2. The pre-tax cost of the premium inside super using NCCs is \$477.

Tax of \$150 is payable on the gross assessable income leaving \$327 which is used to make an NCC. The NCC is not assessable income in the hands of the fund and the fund credits Robert with the value of the deduction it receives for the premium payment. The pre-tax cost is calculated as follows:

Income	\$477
Less income tax (31.5%)	(\$150)
Add benefit of deduction in the super fund	\$58
After-tax income/premium	<b>\$385</b>

### 3. The pre-tax cost of the premium outside super is \$562.

Tax of \$176 is payable on the gross assessable income leaving \$385 which is used to pay the premium. The pre-tax cost is calculated as follows:

Income	\$562
Less income tax (31.5%)	(\$177)
After-tax income/premium	<b>\$385</b>

#### Example 2 – Life cover through super and payment to non-dependants

Lisa is 50 years old, she is on a marginal tax rate of 46.5 per cent and has one non-dependent child, Adam. She has an existing super account with a *service period* of 15 years and a balance of \$300,000. The account consists of a taxable component only. In addition to her existing super, upon her death Lisa would like to leave \$400,000 of life insurance to Adam.

#### Should Lisa hold her life insurance outside of super or via a separate super policy?

In summary, the options for Lisa rank in the following order for tax efficiency:

1. inside super using CCs – pre-tax cost \$977
2. outside of super – pre-tax cost \$1,407
3. inside super using NCCs – pre-tax cost \$1,552.

The Macquarie Life insurance tax calculator can assist with calculations but the following is a description of the key calculations.

#### 1. Super CCs

When insuring inside super Lisa needs to gross up the sum insured for tax payable when the super benefit is paid to Adam. The grossed up level of life cover is \$584,000 (refer to Appendix 1 for calculations). Let's assume that the premium for this level of cover is \$977.

Any tax liability on the assessable income of the contributor is offset by a tax deduction on the CCs. The CCs are assessable income in the hands of the fund but that in turn is offset by a tax deduction on the insurance premium. As a result the pre-tax cost will always be equal to the premium and therefore the premium and pre-tax cost are \$977.

## 2. Outside of super

Lisa does not need to gross up the sum insured as there is no tax payable when insuring outside of super. Let's assume that the premium for \$400,000 of life cover is \$753.

The pre-tax cost is calculated as follows:

Income	\$1,407
Less income tax (46.5%)	(\$654)
After-tax income/premium	<b>\$753</b>

## 3. Super NCCs

As with Super CCs, the life cover needs to be grossed up for tax payable on the super benefit.

Tax of \$722 is payable on the gross assessable income leaving \$830 which is used to make an NCC. The NCC is not assessable income in the hands of the fund and the fund credits Lisa with the value of the deduction it receives for the premium payment. The pre-tax cost is calculated as follows:

Income	\$1,552
Less income tax (46.5%)	(\$722)
Add benefit of deduction in the super fund	\$147
After-tax income/premium	<b>\$977</b>

### **Lisa is considering applying for her insurance via her existing super account. What effect would this have on the decision-making process?**

On the one hand, arranging life cover in the same fund as Lisa's existing super balance has the effect of increasing the tax on the accumulating benefit. On the other, Lisa's 15 year *service period* in her existing super account lowers the effective tax rate on the overall benefit.

The net effect is that the tax payable by Adam on the overall super benefit would be less than if Lisa arranged her insurance in a separate super fund. Lisa's grossed up insurance requirements reduce to \$556,000 (from \$584,000) for the super options. If we assume that the premium payable for this level of cover is \$934, the rank for tax efficiency will remain as follows:

1. inside super using CCs – pre-tax cost now \$934
2. outside of super – as before, pre-tax cost \$1,407
3. inside super using NCCs – pre-tax cost now \$1,484.

### Example 3 – Looking after dependants and non-dependants

Sam is 50 years old and has three children, Rusty, Karen and Lauren. Rusty and Karen are *dependants* and Lauren is a non-dependant for tax purposes. Upon her death Sam would like to leave \$500,000 to each child. She has the following assets:

Non-super	\$500,000
Existing super (all taxable)	\$500,000
<b>Total assets</b>	<b>\$1,000,000</b>

Sam requires an additional \$500,000 via life insurance in order to achieve her objective.

While insuring through super using CCs will provide the most tax efficient way of funding the insurance, different super arrangements can produce different levels of tax.

For example, the taxable component of super benefits (including benefits funded from insurance through super) is taxable if paid to a non-dependant whereas it is tax free if paid to a *dependant*.

#### **An efficient solution**

Sam would not need to gross up the sum insured to cover tax on super benefits if she were to allocate her non-super assets to her non-dependent child, Lauren, and allocate her super (including insurance) to her dependent children, Rusty and Karen.

**Say Sam's existing super account has been accumulated from a large NCC she has made recently so her super account comprises almost entirely of tax free component.**

**Assuming Sam uses a separate super fund for her life insurance, does she still need to be as concerned about the allocation of assets between dependent and non-dependent children?**

The tax free component of a super benefit is not taxable when paid to either a *dependant* or non-dependant.

### **Another efficient solution**

Sam could allocate either her non-super assets (as above) or her existing, non-insured super benefit to her non-dependent child, Lauren, and Lauren would pay little or no tax if death occurs reasonably soon after the contribution is made. During the accumulation phase, earnings generated on super contributions are classified as taxable component for benefits tax purposes. So Sam would need to be conscious that the taxable component of any death benefit ultimately paid is likely to grow over time, which may be significant if she remains alive for many years.

The separate, insurance-funded super benefit will be tax free provided it is paid to her dependent children, Rusty and Karen (but generally not if paid to Lauren).

# Total and Permanent Disablement (TPD) cover – lump sum benefits

## Tax efficiency comparison

Again, we start the analysis with a table of pre-tax insurance costs. What we mean by pre-tax cost in this case is the amount of a client's gross remuneration package that would be needed to pay the premium for a given amount of cover, taking into account any tax payable on benefits. Table 2 shows this pre-tax cost (rounded to two decimal places) for each \$1 of premium (taking into account any possible benefits tax where cover is held inside super).

**Table 2**

Pre-tax cost for each \$1 of premium (payment age 50 and under) – with benefits tax			
Client's Marginal Tax Rate	Non-Super	Super CC	Super NCC
<b>Effective Benefits Tax:</b>	N/A	0% – 15% <sup>4</sup>	0% – 15% <sup>4</sup>
31.5%	\$1.46		\$1.24 – \$1.46
38.5%	\$1.63	\$1.00 – \$1.18	\$1.38 – \$1.63
46.5%	\$1.87		\$1.59 – \$1.87

## Key additional assumptions

The following assumptions are made in addition to those set out on page 4.

### Premium deductibility – non-super

The premiums are not deductible under the non-super arrangement.

### Premium deductibility – super

Under both the CC and NCC options the premiums are fully deductible to the fund trustee.

From 1 July 2011, tax legislation provides that TPD premiums paid by super funds will only be deductible to the extent that the premium covers insured events that would result in the fund being liable to pay a 'disability superannuation benefit'.

<sup>4</sup> Prior to age 55 the taxable component is taxed at 21.5 per cent. However, the taxable component is reduced by the increased tax free amount associated with a disability superannuation benefit. The increased tax free amount reduces the overall Effective Benefit Tax rate applicable to the benefit as a whole. For a person age 50 or less, who has a service period commencing at age 15 or later, the Effective Benefit Tax rate cannot be greater than 15 per cent.

Broadly, that definition requires two medical practitioners to have certified that, because of ill-health, it is unlikely that the client can ever be gainfully employed in a capacity for which he or she is reasonably qualified because of education, experience or training. This means that the cover inside super needs to be more in the nature of 'any occupation' cover to qualify for a full tax deduction.

### 'Own occupation' TPD deductibility trap

There have been numerous developments (including ATO rulings and legislation) affecting the super fund deduction provisions as they apply to TPD premiums over the past few years. The outcome is that premiums for 'any occupation' TPD insurance are typically fully deductible but premiums for 'own occupation' TPD are no longer fully deductible in the 2011/12 and later income years.

A super fund may have a number of options available to determine the deductible part of a premium for 'own occupation' TPD insurance (or other TPD insurance that is not fully aligned with the 'disability superannuation benefit' definition).

Unless the insurer defines the deductible portion of the premium in the policy, the fund may either seek an actuary's certificate or have regard to the *Income Tax Regulations 1997* (Regulations) which prescribe deductible percentages for typical TPD insurance definitions. The Regulations, which have been in place since October 2011, are designed to provide a backstop or default means of claiming a deduction for trustees who wish to avoid the costs associated with actuarial certification. In the case of 'own occupation' TPD insurance, the Regulations provide that the premium is 67 per cent deductible.

As discussed later (see page 17), for clients who require 'own occupation' TPD insurance advisers should consider arrangements which allow the deductible part of the cover to be held inside super and the remainder to be held outside super.

Refer to the MASTech Big Black Book for more information about the prescribed deductible percentages.

### Benefits tax – super

Under both the super CC and NCC options, the benefits paid from the fund will be subject to income tax at the rate of 0 per cent to 21.5 per cent in the client's hands if the client is under age 55, depending on the client's age and fund *service period*. The maximum tax rate drops to 16.5 per cent for clients aged 55 to 59 inclusive, and no tax is payable from age 60.

**For clients age 50 or less:** Table 2 on the previous page shows that (assuming the insured started work aged 15 or later), insuring inside of super is always more tax efficient than insuring outside of super.

**For clients aged 51–54:** The same generally holds true:

- Super CCs: funding TPD (any occupation) insurance with super CCs is always more efficient than via non-super

- Super NCCs: the only circumstances in which funding TPD (any occupation) insurance with super NCCs can be less efficient than non-super is for clients aged 51 to 54 inclusive whose fund *service period* started before they were 29 years of age. (Even in this narrow band of cases, a non-super arrangement would be no more than 2 per cent cheaper pre-tax than insuring via super NCCs.)

**For clients aged 55-59:** The tax rates on super benefits are lower so funding TPD (any occupation) insurance with super is always relatively more appealing on our assumptions.

**For clients aged 60 or more:** No tax is payable on super benefits received by the client so funding TPD (any occupation) insurance with super is relatively more appealing on our assumptions.

## Access to benefits

### Super benefits which can be immediately accessible

Ideally, the definition of TPD under the policy inside superannuation should be aligned as closely as possible with the super law definition of *permanent incapacity*. If the latter definition is satisfied it provides the fund trustee with grounds on which they may pay a benefit (comprising the TPD policy proceeds) to the client immediately. This will be particularly important for clients under the age of 55, since they will typically be unable to satisfy other conditions of benefit release such as commencing a transition to retirement (TTR) pension or 'retirement'.

### 'Own occupation' TPD access trap

For some types of insurance such as own occupation TPD there is a potential mismatch between the insurance policy definition (which determines when insurance proceeds are paid to the fund trustee) and the super law definition of *permanent incapacity*. If this type of insurance is held inside of super it is quite possible that insurance proceeds could be paid to the fund but your client would be unable to satisfy a condition of release in order to receive a benefit immediately.

As discussed on the following page, one way to avoid this trap is to structure own occupation cover so that the part that is aligned with the *permanent incapacity* definition is held inside super and the remainder is held outside super.

### Future policy directions

As part of its Stronger Super reforms, the Government is proposing to require alignment between the insurance definitions for cover held inside super and the payment rules for super benefits to ensure that insurance proceeds can be accessed by fund members at the time a claim is made. This change was announced on 21 September 2011 but at the time of writing it has not become law.

# Rules of thumb

Based on the assumptions outlined, we have distilled the following rules of thumb.

## Super is tax efficient for immediately accessible TPD benefits

**Super CCs:** It can be seen from Table 2 on page 14 that, for clients at the given tax rates, funding TPD cover via super CCs is generally much more tax efficient than doing so by other means where the benefits provided conform with super tax law requirements for deductibility. This is the case notwithstanding that there will typically be tax payable on the benefit paid from the super fund.

**Super NCCs:** Super NCCs are generally a more tax efficient way of funding TPD cover than doing so outside of super where the benefits provided conform with super tax law requirements for deductibility. Again, this is generally the case notwithstanding that there will typically be tax payable on the benefit paid from the super fund. A key exception is discussed below.

**Non-super exception:** Funding TPD cover via non-super will be more tax efficient than funding it via super NCCs (but not super CCs) if the super fund does not credit the client with the value of the deduction for the insurance premium.

## Non-super arrangements may solve 'own occupation' access traps?

To the extent that TPD benefits do not meet super law requirements, it may be preferable for clients to hold the relevant insurance outside of super to ensure immediate access. However, in many cases, this will not produce an optimal tax outcome for clients. In addition, if the Government's Stronger Super proposal is legislated, traditional 'own occupation' TPD insurance will not be able to be held inside super.

## 'Best of both worlds' solution – tax efficiency and access

For clients seeking 'own occupation' TPD cover, one way to both achieve the tax efficiency of a super arrangement and ensure immediate access to insured benefits is to enter a split cover arrangement under which the benefits which meet the super law definition of *permanent incapacity* are insured via super and the balance of the own occupation cover is held outside of super.

If the Government's Stronger Super proposal is legislated, a split cover arrangement will be the only means by which clients with 'own occupation' TPD can benefit from the super tax arrangements.

Superannuation Optimiser available through Macquarie FutureWise is an example of this type of arrangement.

Under a Superannuation Optimiser arrangement the premium paid for the policy held in super is fully deductible. In this regard the ATO has recently issued a private ruling to Macquarie Investment Management Limited, the trustee of the Macquarie Superannuation Plan. The private ruling confirms that the premium paid for the policy held inside super under a Superannuation Optimiser arrangement is fully deductible.<sup>5</sup>

The premium paid for the policy held outside super is typically not tax deductible. This compares with a premium paid for a traditional 'own occupation' TPD policy held outside super which is typically not tax deductible.

Macquarie Life's Active product also offers a Superannuation Optimiser arrangement which is similar to that offered in Macquarie FutureWise.

Under a Superannuation Optimiser arrangement in Macquarie Life Active, the policy held within superannuation provides cover that is aligned with the super law conditions of release for death, *terminal medical condition* and *permanent incapacity*. The remainder of the cover is held under a separate policy that sits outside superannuation. See page 36 for more on Macquarie Life Active.

## MAStech insurance tax calculator

The Macquarie Life insurance tax calculator provided on the Macquarie Life website can be used for specific tax calculations. Also refer to Appendix 2 for specific tax calculation rules for super disability lump sum benefits paid in the event of *permanent incapacity*.

<sup>5</sup> See private ruling 1011660832732. The private ruling was issued to Macquarie Investment Management Limited as trustee for the Macquarie Superannuation Plan. The ruling only binds the Commissioner of Taxation against the beneficiaries of the Macquarie Superannuation Plan, its current trustee and future trustees.

## TPD examples

### Example 1 – ‘Any occupation’ TPD through super

Peter is 45 years old, has 10 years service in his super fund and has a marginal tax rate of 46.5 per cent. Included in the life insurance policy, his adviser has worked out that he needs \$500,000 of any occupation TPD insurance included in the life insurance policy. Let's assume that the premium for \$500,000 of TPD insurance is \$413.

Assuming that Peter uses his existing super fund for this insurance under the super options, the pre-tax cost of the options for Peter are as follows:

1. inside super using CCs – \$445
2. inside super using NCCs – \$707
3. outside of superannuation – \$722.

Detailed analysis follows.

#### 1. Super CCs

The pre-tax cost of the premium is \$445 if funded using super CCs.

The TPD cover must be grossed up by \$38,603 to account for tax on the benefit paid to Peter from the super fund. Refer to Appendix 2 for calculations. So Peter needs \$538,603 of TPD cover to gain an after-tax benefit of \$500,000. We are assuming that the premium for \$538,603 of cover is \$445.

When funding insurance using CCs, any tax liability on the assessable income of the contributor is offset by a tax deduction on the CCs. The CCs are assessable income in the hands of the fund but that in turn is offset by a tax deduction on the insurance premium. As a result the pre-tax cost will always be equal to the premium and therefore the premium and pre-tax cost are \$445.

Refer to Diagram 1 on page 3 and Table 2 on page 14 for further information.

#### 2. Super NCCs

The pre-tax cost of the premium is \$707 if funded using NCCs.

As with Super CCs, the amount of TPD cover needs to be \$538,603 to cover the tax payable.

Tax is payable on the gross assessable income leaving \$378 which is used to make an NCC. The NCC is not assessable income in the hands of the fund and the fund credits Peter with the value of the deduction it receives for the premium payment. The pre-tax cost is calculated as follows:

Income	\$707
Less income tax (46.5%)	(\$329)
Add benefit of deduction in super fund	\$67
<b>After-tax income/premium</b>	<b>\$445</b>

### 3. Outside of super

The pre-tax cost of the premium for \$500,000 cover outside super is \$772. As there will be no tax payable on the insurance proceeds the level of cover does not need to be grossed up to account for tax.

Income	\$772
Less income tax (46.5%)	(\$359)
<b>After-tax income/premium</b>	<b>\$413</b>

### Example 2 – A solution to the need for own occupation TPD: Superannuation Optimiser

Given the nature of Peter's occupation and his education, training and experience, Peter's adviser considers that it would be desirable for him to have the more extensive 'own occupation' cover rather than 'any occupation'. Accordingly, Peter and his adviser have dismissed the prospect of merely having 'any occupation' TPD insurance.

However, they're aware that, while there are potential tax advantages of funding TPD via super, there are also constraints on access to benefits. Specifically, deductibility of premiums and immediate access to benefits are only assured for benefits that meet super and tax law disability definitions.

They consider three options:

1. own occupation within super
2. own occupation outside super
3. own occupation provided via two policies.

Details of each option are on the following page.

## 1. Own occupation within super

An appeal of this strategy is that it is more cost effective than arranging the equivalent net cover outside of super, especially when funding the premium using CCs. Even so, Peter's adviser is concerned that only part of the TPD insurance premium relating to the provision of own occupation TPD cover is deductible within super from 1 July 2011.

A potentially critical disadvantage is accessibility. Because of the specialist nature of Peter's employment, his adviser is concerned that there is a considerable risk that Peter may qualify for 'own occupation' TPD benefits but not the super law definition of *permanent incapacity*. If this was to occur the benefit could be trapped within his super account since he is not old enough to qualify for release of benefits as a TTR pension or on the grounds of retirement.

## 2. Own occupation outside super

The advantage of this option is accessibility, particularly in relation to situations where a disability would qualify under the 'own occupation' definition but not the super law definition. The benefit would be paid directly to Peter, not his super fund.

The disadvantage of this option is the relatively high pre-tax cost of funding the premium.

## 3. Own occupation provided via two policies

To overcome the problems with options 1 and 2, Peter could separate his cover into two distinct parts. It is possible to do this via 2 linked policies available through Macquarie FutureWise (Superannuation Optimiser), as follows:

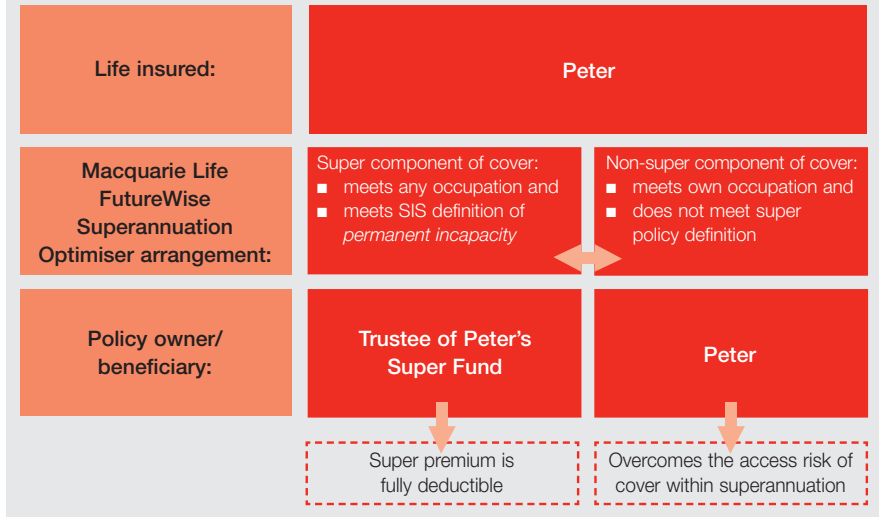
1. a super policy which is basically an 'any occupation' style policy with the additional requirement that Peter meets the super law definition of *permanent incapacity* (that definition being applied as if Macquarie Life was the fund trustee) and
2. a non-super policy which covers the remaining part of the 'own occupation' definition of TPD that is not covered under the super policy.

A claim would first be tested under the super policy. The super policy definition is designed to eliminate the issue of the benefit being trapped within the super fund. If the claim meets the TPD definition under the super policy, the full sum insured is paid to the super fund trustee and is subject to super tax laws.

If the claim meets the TPD definition under the non-super policy, the full sum insured is paid directly to the policy owner of the non-super policy and is not subject to super laws or super taxation.

There is no overlap in definitions of the cover held under the two policies and a benefit is only ever payable under one of the policies at any point in time.

Own occupation TPD provided under a Superannuation Optimiser arrangement



Refer to the Macquarie FutureWise PDS for policy specific definitions.

The level of cover needs to be grossed up to take into account any tax payable should Peter receive a benefit payment from the super environment. Under the Superannuation Optimiser arrangement the level of cover must be the same inside and outside of super and will therefore be \$538,603.

Where the TPD policy is paid outside of superannuation Peter will not be taxed on this payment and therefore the net benefit of \$538,603 will be \$38,603 greater than if it had been paid under the super policy. However, it is worth bearing in mind in these circumstances he will presumably be unable to access his existing super account immediately. So it may be useful to receive the additional insurance benefit immediately, to compensate for the lack of access to his accumulated super.

### Example 3 – Pre-tax cost comparison of own occupation TPD solutions

Peter decides against using a single own occupation policy inside of super due to the potential lack of access to benefits as compared to the Superannuation Optimiser arrangement. So his adviser calculates the pre-tax cost of using a Superannuation Optimiser arrangement with CCs and NCCs and insuring outside of super (assuming that the premium payable for the additional 'own occupation' cover is \$234), as follows:

1. Macquarie Superannuation Optimiser using CCs – pre-tax cost \$882
2. Macquarie Superannuation Optimiser using NCCs – pre-tax cost \$1,144
3. own occupation outside of superannuation – pre-tax cost \$1,158.

Detailed calculations are as follows:

#### 1. Macquarie Superannuation Optimiser using CCs

If funded from CCs the pre-tax cost is equal to \$882, of which \$445 relates to the policy inside super and \$437 relates to the policy outside super.

	Inside Super	Outside Super
Income	\$445	\$437
Less income tax	(\$67)	(\$203)
Add benefit of deduction in super fund	\$67	\$0
<b>After-tax income/premium</b>	<b>\$445</b>	<b>\$234</b>

#### 2. Macquarie Superannuation Optimiser using NCCs

If funded from NCCs the pre-tax cost is equal to \$1,144, of which \$707 relates to the policy inside super and \$437 relates to the policy outside super.

	Inside Super	Outside Super
Income	\$707	\$437
Less income tax (46.5%)	(\$329)	(\$203)
Add benefit of deduction in super fund	\$67	\$0
<b>After-tax income/premium</b>	<b>\$445</b>	<b>\$234</b>

### 3. Own occupation outside of super: The pre-tax cost is calculated as follows:

(Unlike the Superannuation Optimiser scenarios, there is no need to gross up the cover to account for tax.)

Income	\$1,158
Less income tax (46.5%)	(\$538)
After-tax income/premium	<b>\$620</b>

#### Would you recommend a separate super policy to hold the insurance?

In this situation, Peter would benefit from using a separate policy for the insurance.

The tax free component associated with the super benefit will increase thus reducing the tax payable. Refer to Appendix 2 for an explanation of how the increase in the tax free component is calculated and the taxation of TPD benefits paid from super.

# Disability income insurance (DII)

## Tax efficiency comparison

Let's start with the pre-tax cost of disability income insurance. What we mean by 'pre-tax cost' is the amount of a client's gross remuneration package that would be needed to pay the premium. Table 3 shows this pre-tax cost (rounded to 2 decimal places) for each \$1 of premium. In this case we ignore the effects of tax payable by your client on the benefits because we are assuming benefits are fully assessable income in all cases.

**Table 3**

Pre-tax cost for each \$1 of premium			
Client's Marginal Tax Rate	Non-Super	Super CC	Super NCC
31.5%	\$1	\$1	\$1.24
38.5%	\$1		\$1.38
46.5%	\$1		\$1.59

## Key additional assumptions

The following assumptions are made in addition to those set out on page 4.

### Premium deductibility – parity between super and non-super

Premiums in all cases are assumed to be fully deductible to the payer.

In Tax Determination TD 2007/3, the ATO effectively recognises that premiums paid by a super fund trustee are deductible to the extent that they are to enable the trustee to pay *temporary incapacity* benefits in accordance with super law payment standards. This means that premiums may be deductible for policies providing basic income protection benefits until age 65 or even later provided the benefit payment period does not exceed the period of incapacity.

- **Non-super and super with CCs:** The pre-tax cost of \$1 of premiums funded with CCs within the CC cap is the same as the pre-tax cost of the non-super equivalent.
- **Super with NCCs:** To the extent that premiums are funded with NCCs, the pre-tax cost will be greater than using super CCs or insuring outside super.

## DII deductibility trap

The ATO has noted that certain policy features of typical DII policies which do not meet the SIS payment rules, such as when benefits are provided for someone who continues to work part-time, where the value of the cover exceeds the person's remuneration at the time they became ill, or where the level of benefits fluctuate at an annual rate of more than 5 per cent or CPI. The implication is that, where this cover is held inside superannuation, the premium may not be fully deductible.<sup>6</sup>

## Benefits fully assessable

This table ignores tax payable by your client on benefits received because disability income benefits will typically be fully assessable at your client's marginal tax rate under all options. However, note that more favourable treatment may be available for super income streams paid in the event of *permanent incapacity* – see page 27.

## Access to benefits

### Super benefits which can be immediately accessible

The typical conditions of release relied upon by super fund trustees to pay disability benefits are *temporary incapacity* and *permanent incapacity*. If a client meets either of these conditions then basic benefits payable to a super fund trustee under an income protection policy will typically be able to be paid immediately to the client.

### Temporary incapacity – access trap

The *temporary incapacity* condition of release requires a member to have ceased gainful employment because of ill-health, including where the member has ceased temporarily to receive gain or reward under a continuing gainful employment arrangement. Therefore any DII benefits that are payable in circumstances where employment has not ceased or where the member has not been on any unpaid leave may not be accessible.

In addition, temporary incapacity benefits can only be paid in the form of a non-commutable income stream. The view of both the ATO and APRA is that the amount payable cannot exceed pre-disability remuneration levels, and subsequent increases must be within super law indexation constraints. So, to the extent that benefit levels in excess of these limits are required immediately (as opposed to, say, being paid later when the client meets the retirement condition of release) a non-super arrangement may be desirable.

Also, various ancillary benefits (such as payment of various care-related expenses etc) which are available on some income protection policies outside of super may not be payable from a super fund under super law so, if these are required, a non-super arrangement may be a preferable option.

<sup>6</sup> See the Minutes of the 13 September 2011 meeting of the National Tax Liaison Group Superannuation Technical Sub-committee.

## Future policy directions

As noted earlier, the Government is proposing to require alignment between the insurance definitions for cover held inside super and the payment rules for super benefits. If the proposal is legislated then, to the extent DII cover provides inconsistent features, it will need to be held outside superannuation.

### Permanent incapacity – lump sums and normal super income streams can be accessed

By contrast, if a client meets the definition of *permanent incapacity* then there is scope for the super fund trustee to pay benefits in the form of a lump sum or a normal super income stream without constraint on the size of the payments.

This opens up more planning opportunities if the income protection benefits are able to be commuted to a lump sum. The super fund can then pay the benefit to the client as a lump sum (taxed at a maximum of 21.5 per cent) or an income stream benefit (that meets the super law pension standards) on the basis that the client has become permanently incapacitated. A 15 per cent tax offset will be available on any taxable component of the income stream up until the age of 60, and from age 60 the income stream will be tax free.

# Rules of thumb

Based on the assumptions outlined, we have distilled the following rules of thumb.

## Non-super – DII cover is tax efficient for temporary disability

Typically, insuring for income protection outside of super is tax efficient, particularly in circumstances where a client is temporarily (not permanently) disabled.

Where a client becomes permanently incapacitated, there can be tax and other advantages in commuting the income protection benefits and receiving subsequent benefits in the form of super – refer to Example 2 on page 30.

## Super with CCs – DII cover is tax efficient for basic cover

Typically, insuring for basic income protection with super CCs is tax efficient.

Generally it will be preferable for amounts exceeding pre-disability remuneration or for other benefits not readily accessible from super (see above) to be insured outside of super.

## Super with CCs – DII cover with TPD commutation option added appeal

Further, there can be additional appeal in insuring with super CCs in circumstances where a client becomes permanently incapacitated and has the option to commute their income protection benefits to a lump sum – refer to Example 2 on page 30.

In these circumstances one of the potential attractions of the TPD commutation option is that, depending on the fund investment performance, it may provide residual capital when your client attains 65 or dies. It will also provide flexibility to vary the income level, which may have favourable tax and social security consequences.

On the other hand, exercising the TPD commutation shifts the investment risk to the client, which may be managed with the help of an adviser.

## Super with NCCs – DII cover is not tax efficient

Some clients are in a position to contribute amounts right up to their relevant contribution caps. If they do so and want as much of those contributions to be directed towards accumulating retirement savings as possible then they may prefer not to use any of those contributions to fund insurance.

This is more likely to be the case in relation to income protection insurance than TPD or life cover, as income protection premiums would often use up more of the contribution cap. And once the CC cap is exceeded, additional NCCs made to fund income protection insurance have a significantly higher pre-tax cost relative to the non-super alternative.

## DII examples

### Example 1 – Accessing all benefits when DII held in super – ‘extra benefits’ solution

Helen is looking to take out disability income insurance cover by funding the cover through the super fund. However, she is concerned that the extra benefits she requires in her policy may not be payable to her because of restricted access to super benefits.

#### What are her options?

Helen may be able to take out a Macquarie Extra Benefits policy. This will allow Helen to take the disability income insurance inside super and have the extra benefits as a rider policy, which will be paid outside super.

### Example 2 – Receiving DII benefits when held in super

Robert, aged 40, has been unable to work for 30 days due to ill health and is looking at making a claim for a DII benefit via his Macquarie Disability Income Insurance policy. Robert’s monthly benefit is \$10,000.

#### If Robert satisfies the policy’s total disability definition, will he be able to access the benefits?

The definition of total disability under Robert’s policy is closely aligned with the definition of *temporary incapacity* under super law. The super fund trustee is satisfied that Robert has met that condition of release so Robert will be able to access DII benefits from the fund.

Robert has no other income and would like to know what after-tax benefit he will receive.

The monthly benefit is assessable income for Robert.

Ignoring any deductions or offsets that Robert may be entitled to, his after-tax benefit is calculated as follows:

Annual DII income	\$120,000
Less tax on taxable income	(\$32,350)
Less Medicare Levy	(\$1,800)
<b>Annual after-tax income</b>	<b>\$85,850</b>
<b>Monthly after-tax benefit</b>	<b>\$7,154</b>

Refer to Appendix 3 for assumptions and further calculations.

**Assume that Robert has been unable to work for over 12 months and is unlikely to be able to work in future. He is considering converting his DII benefits to a lump sum using the TPD Commutation option. What issues should he consider?**

By taking the TPD commutation option Robert's super account will receive a lump sum of \$1.56 million (ie  $\$10,000 \times 156 = \$1,560,000$ ).

The commutation multiple, which we assume to be 156 in this case, is determined by the age of the insured at the time the benefit is paid.

Once Robert's super account is credited with the lump sum, Robert has a number of options including the following.

### **1. Cashing all or part of the benefit from the fund**

This may be subject to tax but should receive a tax free component (refer to Appendix 2 and TPD cover Example 1 on page 19 for further detail).

### **2. Commencing a super income stream**

From a personal tax perspective, the taxable component of the super income stream will receive a 15 per cent tax offset on the basis that it is considered a 'disability superannuation benefit'.

As a result of the 15 per cent tax offset and reduced level of tax, Robert only needs to take a monthly income stream of \$8,039 from his super account in order to achieve the same after-tax monthly income of \$7,154 had he continued with the DII policy.

Refer to Appendix 3 for assumptions and calculations.

### **3. A combination of 1 and 2**

When assessing the appeal of the TPD commutation option, Robert should consider the possibility of there being a capital value at age 65. Age 65 is the time at which many DII policies cease paying a benefit. By choosing the TPD commutation option, depending on the investment performance of the fund and the extent of his benefit drawdowns, Robert may have a lump sum remaining at age 65 to assist with meeting his living expenses.

The commutation may also be advantageous in the situation where Robert passes away prior to age 65. The DII policy will stop paying a regular benefit on Robert's death whereas under the TPD commutation option there may still be a lump sum remaining that will pass to Robert's beneficiaries.

Robert should also take into consideration the fact that the commutation option shifts the investment risk from the insurer to Robert – he may need to manage the risk with the help of his adviser.

# Trauma cover

## Tax efficiency comparison

Let's start with the pre-tax cost of trauma cover. What we mean by 'pre-tax cost' is the amount of a client's gross remuneration package that would be needed to pay the premium. Table 4 shows this pre-tax cost (rounded to two decimal places) for each \$1 of premium. The premiums in super are grossed up for the 16.5 per cent tax that may be payable by a member aged 55 to 59.

**Table 4**

Pre-tax cost for each \$1 of premium (payment age 55) – with benefits tax (16.5%)			
Client's Marginal Tax Rate	Non-Super	Super CC	Super NCC
31.5%	\$1.46	\$1.41	\$1.75
38.5%	\$1.63		\$1.95
46.5%	\$1.87		\$2.24

## Key additional assumptions

The following assumptions are made in addition to those set out on page 4.

### Premium non-deductibility for super and non-super

Premiums in all cases are assumed to be non-deductible to the payer.

### Super benefits taxed

The super benefits are subject to tax of 16.5 per cent, that is, they are paid to the client at an age from 55 to 59 inclusive and the tax free threshold is not available. It is assumed that the benefits are not payable before age 55 – see 'Access to super benefits' on the following page. Super benefits paid to members aged 60 and over are tax free.

## Access to benefits and other super law issues

### Scope for super fund trustees to effect trauma insurance?

Super law (in particular, the 'sole purpose test' and the 'payment standards') requires super funds to be maintained to provide benefits when particular conditions are met. It does not provide for payment of super benefits from funds in the event of a member acquiring a medical condition which qualifies them for a typical trauma insurance benefit.

This means that a super fund trustee would need to be able to justify effecting trauma insurance taking account of its super law obligations (such as the 'sole purpose test') and the circumstances of the fund overall. In this regard, the ATO has issued Self Managed Superannuation Funds Determination SMSFD 2010/1 which explains that it may be possible for a fund to purchase a trauma policy in respect of a member without breaching the sole purpose test, depending on the circumstances. An unreasonable diversion of contributions to premiums for the trauma cover would be difficult to reconcile with the sole purpose test and the fundamental retirement objective of superannuation.

More recently, on 21 September 2011, the Government announced its intention to require alignment between the insurance definitions for cover held inside super and the payment rules for super benefits to ensure that insurance proceeds can be accessed by fund members at the time a claim is made. If legislated, trauma will not be able to be held inside superannuation.

Trustees of funds should seek their own legal advice as to whether arrangements would comply with super law in particular circumstances.

### Access to super benefits

Given that trauma is not a recognised condition of release for super benefits, if trauma insurance proceeds are received by a super fund trustee, the trustee will not be able to pay them unless and until a condition of release is satisfied such as *permanent incapacity*, commencing a TTR pension, retirement or attaining age 65. Clients will need to assess whether or not this constraint on access to super benefits is problematic given their circumstances.

# Rules of thumb

Based on the assumptions outlined, we have distilled the following rules of thumb.

## Non-super – the safe option for clients requiring immediate access to benefits

For a client who would require immediate access to the insurance proceeds in the event of acquiring a trauma condition and who is both under age 65 and not in a position to satisfy the retirement condition of release, a non-super trauma insurance arrangement is preferable.

## Non-super – more tax efficient than super NCCs

In any case, the likelihood of tax being payable on benefits (unless the client has already attained age 60) means that it will typically be more tax efficient to arrange trauma insurance outside of super than to fund it inside super using NCCs.

## Super CCs – tax efficiencies if overcome access and other super law constraints

For a client (both as a member and, in the case of a self managed super fund, as a trustee/director of the fund) who is satisfied that the super law constraints referred to above are not an issue, it may be worth contemplating trauma insurance funded by super CCs. However, consideration would need to be given to the extent to which funding in this way diverts savings away from accumulating retirement benefits.

## Trauma example

### Example 1 – Accessing trauma insurance benefits

Albert (aged 50) holds trauma insurance of \$150,000 outside of super to assist in meeting his medical and living expenses (including mortgage repayments) in case of a trauma event.

Albert recently suffered a stroke requiring him to take two months off work without pay. Albert was fortunate and has been able to resume his previous role and is almost back to full health.

Albert was paid his trauma benefit of \$150,000 which was essential to fund his medical and living expenses during his time off work. Without this cover Albert would have some significant cash flow issues.

Had this insurance been held inside super the trauma benefit would be paid to his super account. As Albert is unable to satisfy the *permanent incapacity* condition of release (or any other condition of release) his trauma benefit would remain in his super account and be inaccessible.

# A new type of insurance cover in Australia

While the focus in this booklet has been on traditional types of insurance, some aspects of the analysis are relevant to a new type of life insurance cover now available in Australia which combines a number of traditional types of life insurance a client may need.

An example of such a product is Macquarie Life Active which provides cover for death, terminal illness and all major health events (for example, cancer, heart attack, stroke or depression). Under this type of cover, there is potential for multiple claims to be paid on the policy based on the severity of the client's condition.

While some parts of this cover cannot be held within superannuation, a client may choose to structure the insurance under a Superannuation Optimiser arrangement which, in relation to Macquarie Life Active cover, involves:

- a policy held by a super fund which provides cover for insured events that align with conditions of release in super law (ie death, *terminal medical condition* and *permanent incapacity*), and
- a separate, linked non-super policy providing the remainder of the cover.

## Premium deductibility – non-super

The premium is typically not deductible where the cover is held outside superannuation.

## Premium deductibility – super

Under a Superannuation Optimiser arrangement in Macquarie Life Active, the premium paid for the policy held within superannuation is generally tax deductible to the super fund. The premium paid for the non-super policy is generally not tax deductible.

## Benefits tax – super

The tax treatment of any benefits paid will depend on the circumstances in which they are paid from the fund.

See the Life cover section for the tax treatment of benefits paid on a member's death or to a member suffering from a *terminal medical condition*. See the TPD cover section for the tax treatment of benefits paid on *permanent incapacity*.

# Glossary

**Any occupation:** The insured person, due to injury or illness, has been absent from work for a continuous period of at least three months, and in our opinion, is incapacitated to the extent that they are unlikely ever again to be able to engage in *any occupation*.

## Dependant for tax and super law purposes:

Beneficiary	Dependant under super law?	Dependant for tax purposes?
Spouse	Yes	Yes
Former Spouse	No	Yes
Child under age 18	Yes	Yes
Child of age 18 or more	Yes	No
Person in interdependency relationship	Yes	Yes
'Ordinary meaning' dependant	Yes	Yes
Other	No	Yes (only in limited circumstances) <sup>7</sup>

**Disability superannuation benefit:** A super benefit paid to a person because he or she suffers physical or mental ill-health and where two legally qualified medical practitioners have certified that, because of the ill-health, it is unlikely that the person can ever be gainfully employed in a capacity for which he or she is reasonably qualified because of education, training or experience.

**Own occupation:** The insured person, due to injury or illness, has been absent from work for a continuous period of at least three months, and in our opinion, is incapacitated to the extent that they are unlikely ever again to be able to engage in their *own occupation*.

<sup>7</sup> In certain circumstances, if an individual who is not otherwise a tax dependant receives a death benefit lump sum in relation to a person who died in the line of duty as:

- a member of either the:
    - Defence Force, or
    - Australian Federal Police, or
  - a protective services officer,
- they will be treated as a tax dependant.

**Partial disability:** The insured person is, solely as a result of injury or *illness*:

- unable to perform at full capacity one or more of the duties of their *usual occupation* necessary to produce income as confirmed by a *medical practitioner*,
- is gainfully employed but their *post-disability income* is less than *pre-disability income*,

and is under the regular care and following the advice of a *medical practitioner*.

**Permanent incapacity:** Physical or mental ill health where the trustee is reasonably satisfied the member is unlikely to engage in gainful employment for which the member is reasonably qualified by education, training or experience.

**Retirement:**

- from preservation age, if an arrangement under which the member was gainfully employed has ended, and the trustee is reasonably satisfied that the member intends never to be gainfully employed for at least 10 hours per week or
- from age 60, if an arrangement under which the member was gainfully employed has ended after turning age 60.

Either definition can be relied upon from age 60.

**Service period:** The service period for the purposes of calculating tax on a superannuation lump sum benefit is typically the period (calculated in days) starting from the day the relevant client joined the fund – that is, the period of fund membership. However, the period may start on an earlier day where:

- the benefit is (at least partly) attributable to an earlier benefit which has been rolled over into the current fund and it had an earlier service period – the service period of the current benefit will generally be calculated from the first day of the service period of the rolled over benefit
- the fund is a standard employer-sponsored arrangement – in many cases the service period will be calculated from the first day of employment with a relevant employer. Note that the employment period is typically not taken into account in calculating the service period for retail and SMSF superannuation fund arrangements.

**Superannuation Optimiser:** Under the super component (the part held under the policy owned by the trustee of a super fund):

- the insured person meets the *any occupation* definition
- the insured person meets the definition of permanent incapacity as defined in the *Superannuation Industry (Supervision) Act 1993* (applied as if Macquarie Life was the trustee of the relevant super fund) and as amended from time to time.

Under the non-super component (the part held under the non-super policy):

- the insured person meets the *own occupation* definition
- the insured person does not meet the super component part of the definition.

Refer to the Macquarie FutureWise PDS for policy specific definitions.

**Temporary incapacity:** Physical or mental ill health that has caused the member to temporarily cease gainful employment, but not permanent incapacity.

**Temporary incapacity cashing constraint:** Benefits (other than member-financed and mandated employer-financed benefits) may be accessed as a non-commutable income stream to continue the pre-temporary incapacity gain or reward for period of incapacity.

**Terminal medical condition:**

- two registered medical practitioners have certified, jointly or separately, that the person suffers from an illness, or has incurred an injury, that is likely to result in the death of the person within a period (the certification period) that ends not more than 12 months after the date of the certification, and
- at least one of the registered medical practitioners is a specialist practicing in an area related to the illness or injury suffered by the person, and
- for each of the certificates, the certification period has not ended.

**Total disability:** The insured person is, solely as a result of injury or illness:

- unable to perform one or more of the duties of their usual occupation necessary to produce income as confirmed by a medical practitioner,
- not gainfully employed in any capacity,

and is under the regular care and following the advice of a medical practitioner.

# Appendix

## Appendix 1

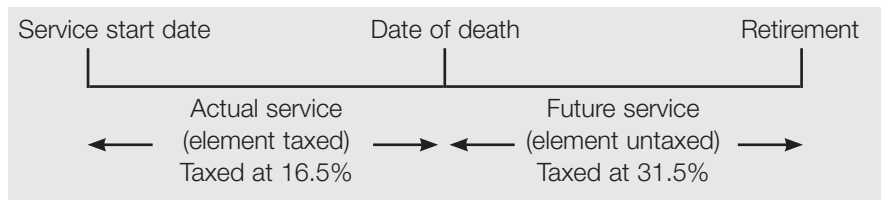
### Life Cover example 2, page 10 – Life cover through super and payment to non-dependants

In this example the life insurance has been grossed up to account for tax payable on super benefits paid to a non-dependant.

In order for Lisa to leave her child a benefit of \$400,000, she requires \$584,000 when insuring inside super.

The super benefit is funded entirely from the insurance policy and therefore is comprised entirely of taxable component. This taxable component is split into an 'element taxed' and an 'element untaxed' as shown in the diagram below. The element untaxed is calculated by working out the 'future service' component of the benefit. Broadly, the future service is the period from death through until the time the client would have turned 65. The element taxed represents the 'actual service' which is the *service period* for the lump sum.

The element taxed component is taxed at 16.5 per cent while the element untaxed component is taxed at 31.5 per cent.



In determining the appropriate level of insurance cover we have used the worst case scenario and have assumed there is no actual service. Therefore the super benefit paid from the insurance policy is all element untaxed and taxed at 31.5 per cent.

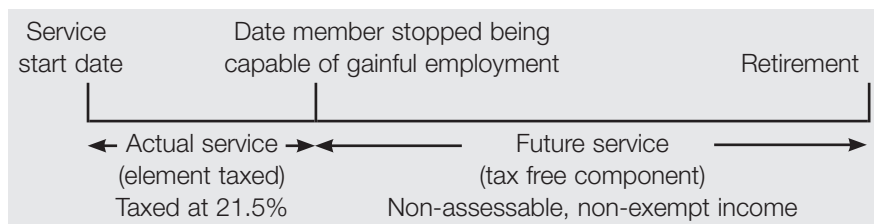
A super benefit of \$584,000 consisting solely of element untaxed component when taxed at 31.5 per cent provides Adam with a benefit of approximately \$400,000.

## Appendix 2

### TPD Cover example 1, page 19 – ‘Any occupation’ TPD through super

In this example the TPD insurance has been grossed up to account for tax payable on the benefit paid to Peter.

The super benefit (consisting of the accumulated balance and the insurance proceeds) will consist of two components, the tax free and taxable component as shown in the diagram below.



In addition to any existing tax free component of the accumulated balance, a tax free component is worked out by calculating the future service component of the benefit. The future service is generally the period from the date the member stopped being capable of gainful employment through until the time the client would turn 65. The taxable component is the amount of the benefit less the tax free component and, in the case where there is no accumulated tax free component, represents actual service which is the *service period* for the lump sum.

In this case the taxable component consists solely of element taxed. As Peter is under the age of 55 the element taxed component will be taxed at 21.5 per cent.<sup>8</sup>

Peter has future service of approximately 20 years and approximately 10 years of actual service. Therefore, assuming his accumulated balance (if any) has no tax free component, approximately two-thirds of Peter's benefit will be tax free with the remaining one-third being taxed at 21.5 per cent (ignoring any tax free component that may arise if insurance is funded with NCCs). Peter will pay tax of \$38,603 resulting in an after-tax TPD benefit of \$500,000.

All of the taxable component is included in assessable income however the amount attracts a tax offset in order to reduce the effective tax rate to 21.5 per cent (including Medicare levy).

<sup>8</sup> If Peter was over the age of 55 the taxable component – element taxed would effectively be tax free up to any remaining low rate cap (maximum of \$165,000 in 2011/12). The low rate cap is a lifetime limit (indexed annually with Average Weekly Ordinary Time Earnings and rounded down to the nearest \$5,000) and once the cumulative level of taxable component received exceeds this cap the amount above the cap will be taxed at 16.5 per cent.

## Appendix 3

### DII Cover example 2, page 30 – Converting DII benefits to a lump sum – TPD commutation solution

In the example below, we compare the tax efficiency of continuing to receive a DII benefit versus commuting DII policy to a lump sum and drawing an income stream from a super account.

As already shown, under the DII option Robert's tax and cash flow position is calculated as follows:

Annual DII income	\$120,000
Less tax on taxable income	(\$32,350)
Less Medicare Levy	(\$1,800)
Annual after-tax income	<b>\$85,850</b>
Monthly after-tax benefit	<b>\$7,154</b>

If Robert is eligible and chooses the commutation option then subsequently draws an income stream from his super account, the income received will attract a 15 per cent tax offset. This tax offset allows Robert to draw a monthly income stream of \$8,039 in order to achieve the same after-tax position.

Calculations follow:

Annual super income stream	\$ 96,471
Less tax on taxable income	(\$23,644)
Less Medicare Levy	(\$1,447)
Add 15% tax offset	\$14,470
Annual after-tax income	<b>\$85,850</b>
Monthly after-tax benefit	<b>\$7,154</b>

The above calculations are based on the 2011/12 tax rates and thresholds. All figures have been rounded to the nearest dollar.

In the example we have assumed that the income stream is fully taxable and that Robert will receive a 15 per cent tax offset on this income.

If Robert's super account included a tax free component, a portion of the income stream would be tax free. For instance, if 30 per cent of Robert's account was tax free component then 30 per cent of the income stream would also be tax free.

The ATO takes the view that an increase in the tax free component that applies in respect of lump sums that qualify as 'disability superannuation benefits' does not arise where benefits are transferred within the same fund to commence an income stream (see ATO ID 2009/125). However, it does potentially apply in respect of a lump sum that is rolled over to another superannuation fund.

## Appendix 4

### Pre-tax cost formulae

Death benefit formula – tax dependant

Non super	Super Concessional Contribution (CC)	Super Non-concessional Contribution (NCC)
Pre-tax cost = $\frac{\$1}{(1-MTR)}$	Pre-tax cost = $\frac{\$1 \times (1-SF \text{ tax})}{(1-SF \text{ tax})}$	Pre-tax cost = $\frac{\$1 \times (1-SF \text{ tax})}{(1-MTR \text{ tax})}$

TPD benefit formula

Non super	Super Concessional Contribution (CC)	Super Non-concessional Contribution (NCC)
Pre-tax cost = $\frac{\$1}{(1-MTR)}$	Pre-tax cost = $\frac{\$1 \times (1-SF \text{ tax})}{(1-SF \text{ tax})(1-BF \text{ tax})}$	Pre-tax cost = $\frac{\$1 \times (1-SF \text{ tax})}{(1-MTR)(1-BF \text{ tax})}$

Disability income insurance formula

Non super	Super Concessional Contribution (CC)	Super Non-concessional Contribution (NCC)
Pre-tax cost = $\frac{\$1 \times (1-MTR)}{(1-MTR)}$	Pre-tax cost = $\frac{\$1 \times (1-SF \text{ tax})}{(1-SF \text{ tax})}$	Pre-tax cost = $\frac{\$1 \times (1-SF \text{ tax})}{(1-MTR)}$

Trauma benefit formula

Non super	Super Concessional Contribution (CC)	Super Non-concessional Contribution (NCC)
Pre-tax cost = $\frac{\$1}{(1-MTR)}$	Pre-tax cost = $\frac{\$1}{(1-SF \text{ tax})(1-BF \text{ tax})}$	Pre-tax cost = $\frac{\$1}{(1-MTR)(1-BF \text{ tax})}$

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