

**Mark Gleeson, IOOF**

Mark Gleeson is a senior technical services manager at IOOF. He has almost 20 years' financial planning industry experience, with particular experience in superannuation, insurance through super, retirement income streams and strategy development. Previously, Mark held technical services roles at Perpetual and Asteron. His qualifications include a Bachelor of Economics and Certified Financial Planner designation.

Strategies to manage TPD payments through super

Mark Gleeson

As many advisers do not provide advice on managing total and permanent disablement (TPD) payments on a frequent basis, this paper provides a refresher to help them ensure their knowledge is up to date. Further, it explores lump sum payments, income streams and other options to maximise social security payments.

Accessing a TPD benefit through superannuation

To access a TPD insurance benefit from a superannuation fund, a client must initially satisfy the insurance policy definition.

If a client's policy was in place before 1 July 2014, the TPD definition could vary from the current definitions. For example, the policy may have an 'own occupation' definition, 'homemaker' definition or a modified TPD definition.

If the policy definition is satisfied, the proceeds are paid from the insurer and added to the client's superannuation balance but will not be treated as a superannuation contribution. At this point, the insurance proceeds increase the taxable component.

To access money as a lump sum or income stream, the permanent incapacity condition of release or other condition of release must be satisfied.

Permanent incapacity occurs when a client has physical or mental ill-health, and the trustee is reasonably satisfied that they are unlikely to engage in gainful employment for which they are reasonably qualified by education, training or experience. The fund trustee generally requests medical certification from two legally qualified medical practitioners when making an assessment.

The form of a TPD benefit

When the permanent incapacity definition is satisfied, the amount in the superannuation fund becomes an unrestricted non-preserved component. This simply means that the funds can be accessed as a lump sum, income stream, or a combination of both. A client can leave the funds in the accumulation phase of superannuation indefinitely.

Many clients only consider taking the lump sum, but it is important to assess other strategies that are more tax-effective or which may increase social security payments.

Tax on a disability benefit

Disability superannuation benefits can be paid to a member as a lump sum or income stream, and the relevant tax implications are summarised in Table 1.

Table 1. Taxation of lump sum and income stream payments

Age	Component	Tax on lump sum	Tax on income stream payments
Age 60 or over	Total benefit	Nil	Nil
Under preservation age	Tax-free	Nil	Nil
	Taxable—taxed	20%*	Marginal tax rate less 15% tax offset
Between preservation age and age 60	Tax-free	Nil	Nil
	Taxable—taxed	First \$225,000 Nil (2021/22 FY) Excess at 15%*	Marginal tax rate less 15% tax offset

*Plus 2% Medicare levy where applicable

Tip

Watch out for the addition of the taxable component of a superannuation lump sum or income stream to assessable income if a client is under age 60, as the outcome could impact their entitlements or obligations related to income (for example, the family tax benefits, co-contribution, child support obligations and Division 293 tax).

The lump sum option

There is an additional tax concession provided to a lump sum or rollover, known as a 'disability super benefit'.

The tax-free component is increased if the benefit is paid because of ill-health, and two legally qualified medical practitioners certify the client is unlikely to be gainfully employed in a position for which they are reasonably qualified due to education, experience or training.

The fund trustee must obtain two certificates from qualified medical practitioners to increase the tax-free component. The fund trustee would normally have already requested these details for the permanent incapacity assessment.

The tax-free component of the benefit is increased to broadly reflect the period the client would have expected to be gainfully employed. The existing tax-free amount in the superannuation fund is increased by an amount which is calculated as follows:

$$\text{Amount of benefit} \quad \times \quad \frac{\text{Days to retirement}}{(\text{service days} + \text{days to retirement})}$$

Days to retirement: The number of days from the day on which the person ceased being capable of being gainfully employed to their last retirement date.

Last retirement date: If a person's employment or office would have terminated when they reached a particular age or completed a particular period of service—the day they would reach the age or complete the period of service (as the case may be); or in any other case the day on which they would turn 65.

Service days: The number of days in the service period for the lump sum.

Any days that are included in both 'service days' and 'days to retirement' are to be counted only once. The Australia Taxation Office's 'Calculating components of a super benefit' webpage provides more information on this topic.

Example: Lump sum and increased tax-free component

Archana, 47 (date of birth 23 January 1974), has \$100,000 in superannuation (all taxable component) with any occupation TPD cover of \$900,000. Archana sustains an injury, and the insurer accepts

her TPD insurance claim, paying the benefit into her superannuation fund.

An amount of \$1,000,000 now sits within the account, all as a taxable component. Archana requests that the trustee releases the benefits under permanent incapacity, and provides two medical certificates. She wants to receive the full amount as a lump sum and to understand the tax consequences if the date of disability is 1 July 2021.

The start date of Archana's fund is 11 April 2009. The trustee generally assumes a person would retire at age 65, that is, 23 January 2039 for Archana. After applying the formula shown previously, the trustee calculates the increase in the tax-free component as follows:

$$\begin{aligned} & \$1,000,000 \quad \times \quad \frac{6,416 \text{ (days to retirement)}}{4,464 \text{ (service days)} + 6,416 \text{ (days to retirement)}} \\ & = \$589,705 \end{aligned}$$

Days to retirement = 6,416 (1 July 2021 to 23 January 2039)

Service days = 4,464 (11 April 2009 to 1 July 2021)

The remaining amount of the lump sum is \$410,295 and is an all taxable component (element taxed).

As Archana is under preservation age, the taxable component of \$410,295 is added to assessable income and taxed at a maximum rate of 22%. This results in \$90,265 tax payable and a net benefit of \$909,735.

To reduce Archana's tax payable, she could consider retaining part of the benefit in the accumulation phase or commencing an income stream. Further, she could roll over the benefit to another provider and request the trustee (of the original fund) to increase the tax-free component.

In hindsight, if Archana required a net lump sum benefit of \$1,000,000, the sum insured should have been grossed up to allow for the tax payable.

Tip

When including TPD insurance within superannuation, an adviser and their client may want to look at selecting a fund with a later eligible service date to decrease the total service and increase the tax-free component.

The income stream option

An account-based pension (ABP) option paid from the superannuation fund is particularly tax-effective in cases of permanent incapacity, due to the tax-free earnings within the fund and tax concessions on pension payments.

A client receiving a disability superannuation income stream before reaching their preservation age receives a 15% tax offset on the taxable component of each pension payment. The tax-free component is tax free. From preservation age, the ABP is taxed normally.



The quote

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Example: Income stream option

Continuing the previous example of Archana, instead of receiving the full \$1,000,000 benefit as a lump sum, Archana decides to take \$400,000 to clear debts and commence an income stream with the remaining amount of \$600,000 (all taxable component).

The income stream commenced from Archana's fund is simply an ABP. The pension has a minimum payment of 2% for the 2021/22 financial year (as Archana is under age 65), and the earnings within the ABP are tax-free. The taxable component of the payments is subject to a 15% tax offset.

Lump sums can be accessed at any time, with any tax payable being based on the components. The transfer balance cap (TBC) is not a problem for Archana, as the commencement value is below \$1.7 million.

In short, the tax treatment of the ABP compares favourably to alternative investments available to Archana.

An adviser and their client will need to consider the TBC (currently \$1.7 million*) if part or all of the benefit is received as a disability superannuation income stream.

**This assumes the client had no TBC account prior to 1 July 2021, otherwise their TBC is between \$1,600,000 and \$1,700,000.*

This cap applies on the total amount that is transferred from accumulation to pension phase. When a disability superannuation income stream is commenced, a credit applies to the transfer balance account.

Tip

If an ABP is commenced from the superannuation fund that received the TPD insurance, the trustee would not increase the tax-free component using the disability superannuation benefit formula.

However, if the superannuation fund is rolled over to another provider, the trustee increases the tax-free component. Clients should identify their preferred income stream provider before commencing an ABP.

Caution: Contrived arrangements may be considered tax avoidance, and multiple rollovers or other unnecessary transactions should be avoided.

Retain funds in superannuation option

Another option upon receiving a TPD insurance benefit is to simply leave the funds in accumulation phase where a maximum 15% tax applies on fund earnings. Lump sums can be withdrawn from the unrestricted non-preserved component as needed, being mindful of the tax consequences outlined previously. Any earnings growth within the fund forms part of the preserved amount.

Centrelink considerations

From a Centrelink perspective, any amount held in the accumulation phase of superannuation is not assessed under the assets test or income test when an applicant

is under Age Pension age. In contrast, the amount in the accumulation phase of superannuation is assessed as an asset and deemed under the income test from Age Pension age.

The favourable assessment below Age Pension age may allow a client to retain some of their money in the accumulation phase of superannuation and apply for the Disability Support Pension, if eligible.

Amounts held in ABPs are fully assessed under the assets test. Any new ABP commenced from 1 January 2015 is deemed under the income test.

Comparing the options

Table 2 summarises what advisers need to consider for the strategies detailed in this paper. In practice, a combination of two or more options may satisfy the client's objectives.

Table 2. Applicable strategies and considerations

Strategy	Considerations
Lump sum	<ul style="list-style-type: none"> Clear debts and meet upfront expenses (e.g. paying for modifications to the home). Significant tax may apply under preservation age (up to 22% tax on taxable component). Between preservation age and under age 60, the taxable component above the low-rate cap is taxed at up to 17%. The tax-free component should be increased by the fund.
Income stream	<ul style="list-style-type: none"> Satisfy ongoing expenditure requirements. Tax-free earnings within the ABP. Tax-effective income if under age 60: <ul style="list-style-type: none"> – 15% tax offset on the taxable component – No tax on the tax-free component. Tax-free income from age 60. TBC between \$1.6 million and \$1.7 million (depending on whether a client commenced a retirement phase income stream prior to 1 July 2021) applies.
Retain funds in superannuation	<ul style="list-style-type: none"> Tax-effective environment, maximum tax of 15% on fund earnings. Superannuation is not assessed under Centrelink means tests if applicant is under Age Pension age. Applicant may claim Disability Support Pension (if eligible). A partner may apply for Carer Payment and/or Carer Allowance if they provide care.

Conclusion

There are significant advice opportunities for clients who receive a TPD insurance benefit into their superannuation fund. Clients may be keen to take a lump sum from superannuation, although the tax payable may be substantial. A lump sum sufficient to satisfy immediate needs can be a good option combined with an ABP to provide ongoing income. The TBC should be considered before commencing an income stream. Retaining some funds in the accumulation phase may assist a client maximise their Disability Support Pension. **FS**