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INSURANCE INSIDE SUPER POST REFORM

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FPA Dimension
Critical Thinking

ASIC Knowledge Area
Superannuation

INCLUDES:

- Transfer Balance Cap
- Death benefit income stream
- Retirement phase income stream
- Account based pension

The introduction of the transfer balance cap (TBC) from 1 July 2017 has important implications for holding life insurance inside superannuation.

The TBC effectively restricts the amount of superannuation, including insurance proceeds, that can be received as a death benefit income stream to $1.6 million and any excess must be cashed out of the superannuation system.

This has caused some financial planners to question whether large life insurance policies should continue to be held inside superannuation, as the payment of a death benefit income stream will effectively 'use up' the beneficiary's TBC, leaving little or no cap available for the beneficiary's retirement.

However, when compared to investing insurance proceeds outside of superannuation, the differences in taxation mean that death benefit income streams often provide a better outcome.

In addition, the strategy of taking lump sum commutations from a death benefit income stream may result in the beneficiary having access to at least a partial TBC at retirement.

TRANSFER BALANCE CAP AND LIFE INSURANCE PROCEEDS INSIDE SUPER

Following the death of a client, proceeds from life insurance cover held inside superannuation form part of the deceased's superannuation account. This superannuation death benefit must then be cashed as a lump sum, one or more retirement phase income streams (only if it is paid to the deceased's spouse, minor child, a child who is severely disabled, adult child under 25 and a financial dependant, or interdependent relation), or a combination of both.

The ability to commence a death benefit income stream and retain insurance proceeds inside the tax-effective superannuation environment, has long been held as one of the advantages of holding insurance inside super.

Prior to the introduction of the TBC, there was no limit as to how much could be converted to a death benefit income stream. However, from 1 July 2017, the TBC has effectively put a $1.6 million limit on the amount of insurance proceeds (along with other benefits) that can be transferred to commence a death benefit income stream. Any insurance proceeds exceeding the beneficiary's TBC must be cashed out as a lump sum death benefit.

As a result, advisers should review clients with life insurance inside super where the sum insured (together with the client's super balances) exceeds the TBC to ensure the compulsory cashing of the amount above the TBC is not going to adversely impact the client.

Furthermore, as the TBC is a lifetime cap, the commencement of a death benefit income stream will use up some or all of the beneficiary's TBC, reducing the amount available at retirement to commence further retirement phase income streams. In addition, if the death benefit income stream equaled or exceeded the TBC, the beneficiary will not be able to increase their unused TBC by future indexation.

For example, Gina is a 40-year-old who commenced a death benefit income stream for $1.6 million due to the death of her husband. She is deemed to have fully exhausted her TBC and will not be able to increase her TBC by future indexation. When Gina reaches retirement age, she will not be able to transfer any superannuation benefits accumulated into tax exempt 'retirement phase' income streams.

This early exhaustion of her TBC has created the following conundrum: Should she take the death benefits (including insurance proceeds) as an income stream and use up her TBC, or should she cash out the death benefit and invest the proceeds outside of super in her personal name, allowing her to commence an income stream with her superannuation in retirement?

After modeling a number of scenarios, in most cases it appears that a beneficiary commencing a death benefit income stream and using up their TBC produces a better outcome. The main reason is that earnings are tax-exempt in the retirement phase and beneficiaries are entitled to a 15 per cent tax offset on the taxable portion of the drawdowns from a death benefit income stream (or drawdowns are tax-free if either the deceased or the beneficiary are age 60 or over).

In contrast, when insurance proceeds are invested outside of super in the beneficiary's personal name, all assessable earnings are taxed at the beneficiaries' marginal tax rate. Even though this strategy allows the client to commence an income stream with their own superannuation in retirement, generally, the client would have paid more tax outside of super compared to commencing a death benefit income stream.

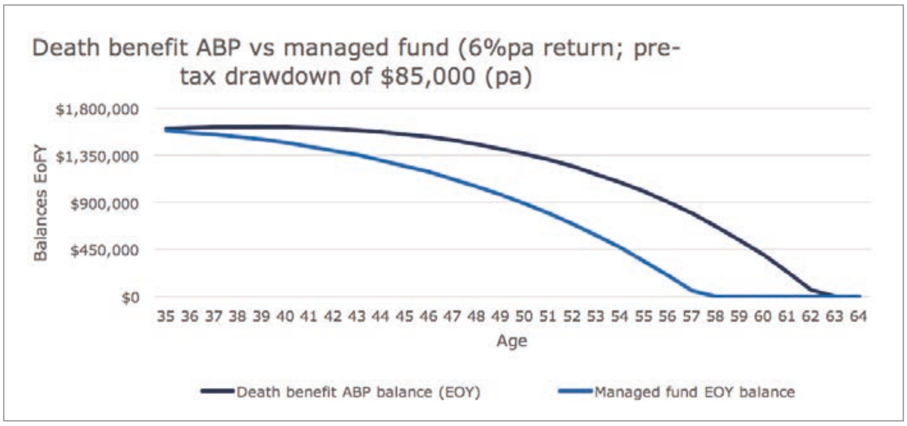
CASE STUDY

Adrian was working as a management consultant before dying at age 40. He is survived by his wife Elaine, aged 35, and two young children. Fortunately, Adrian took out life insurance inside super and nominated Elaine as the sole beneficiary.

The trustee of the super fund informs Elaine that she is entitled to receive a total super death benefit of $1.6 million, of which she can take either a lump sum, income stream or combination.

Elaine works part-time as an accountant and earns $85,000 per annum. She will need additional pre-tax income of $85,000 per annum to maintain her current lifestyle.

Diagram 1



CASE STUDY: PART 1 – $85,000PA INCOME REQUIREMENT

We compare the following two scenarios:

1. Commence a $1.6 million death benefit account based pension and drawdown pre-tax income of $85,000 per annum (indexed at 3 per cent per annum) from the account based pension (ABP). Payments from the death benefit income stream will be split between minimum pension payments and lump sum commutations, resulting in the best TBC and income tax outcomes (see Tip section later in the article); or

2. Cashout the insurance proceeds as a lump sum and invest in managed funds. Drawdowns from the managed funds are adjusted to ensure the same net cashflow is achieved as scenario 1.

Other relevant facts and assumptions:

- Elaine's existing super balance is $100,000 (100 per cent taxable component).
- Retirement age is 65 and number of years to retirement is 30.
- Investment return net of fees is 6 per cent per annum (ignoring franking credit and incorporates capital gains).
- Wages and TBC is indexed at 3 per cent per annum.
- Annual income at retirement is $50,000 per annum in today's dollars, which is equivalent to $121,363 in future dollars (indexed at 3 per cent per annum).

RESULT – PRE-RETIREMENT

As illustrated in Diagram 1, where proceeds are invested in managed funds outside of super, the capital runs out five years earlier than compared to retaining funds inside super as a death benefit income stream. This is because the tax payable on earnings outside of super outweighs the tax payable on the pension payments from the ABP. In order to receive the same amount of net income, more needs to be withdrawn from the managed fund investment.

For example, in the first year under scenario 1, $85,000 from the death benefit income stream plus $85,000 salary will result in net (after tax) income of $133,858. Under scenario 2, if Elaine invests in managed funds, she needs to withdraw $107,160 from managed funds to supplement her salary to achieve the same after tax income of $133,858.

It is worth noting that the $85,000 drawdown from the death benefit income stream consists of a monthly 4 per cent minimum pension payment, with the remainder taken as commutations. Refer to the Tip section after the case study for a detailed explanation of the drawdown strategy.

RESULT – RETIREMENT AND TRANSFER BALANCE CAP

Under scenario 1, Elaine uses up her $1.6 million TBC when she commenced the death benefit income stream and she will not be able to increase any unused TBC by future indexation.

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However, as any excess of the minimum pension payment taken as lump sum commutations are 'debits' against Elaine's transfer balance account, when Elaine retires at age 65, her transfer balance account is -$745,953. This means that she will have available TBC space of $2,345,953.

While this is significantly lower than the TBC of $3,800,000 (indexed at 3 per cent per annum for 30 years) that would be available under scenario 2, it is more than enough to convert Elaine's entire accumulated superannuation savings of $1,255,306 to the tax-exempt retirement phase.

Therefore, Elaine's ability to convert her entire accumulated superannuation into the tax-exempt retirement phase is not affected by her decision to take the death benefit as an income stream.

CASE STUDY: PART 2 – MINIMUM DRAWDOWN

Instead of drawing down $85,000 per annum (indexed) of gross income each year, Elaine draws the minimum 4 per cent income from the death benefit income stream. All other assumptions are the same as in part 1 of the case study.

We compare the following two scenarios (Table 1):

1. Commence a $1.6 million death benefit ABP and drawdown 4 per cent minimum; or

2. Cashout the insurance proceeds as a lump sum and invest in managed funds. Drawdowns from the managed funds are adjusted to ensure the same net cashflow is achieved as scenario 1. (Refer to Table 1.)

Due to the tax concessions on pension assets and the 15 per cent tax offset on the death benefit pension payments, after 30 years, scenario 1 ended up significantly better than scenario 2.

Given Elaine is only drawing down the minimum 4 per cent per annum, some of the earnings will be accumulated overtime, resulting in the balance of the death benefit income stream at $2,797,616 after 30 years. This is more than double the amount accumulated if held outside of super under scenario 2.

In terms of the TBC, under scenario 1, Elaine has no TBC at retirement, so her entire accumulation phase super of $1,255,306 will have to be retained in accumulation phase. In contrast, under scenario 2, Elaine will have a TBC of $3,800,000 available ($1.6 million indexed at CPI of 3 per cent per annum). This allows Elaine to convert her entire super balance of $2,587,104 into an ABP (assuming the funds held outside of super are contributed to super over a period of time).

Table 2 compares the two scenarios. Scenario 1 results in an account balance of $6,658,043 at age 90, whereas scenario 2 results in an account balance of $1,875,553. This represents $1,310,084 and $369,047 respectively in today's dollars. (Refer to Table 2.)

This case study demonstrates that using up the TBC prior to retirement in the form of a death benefit income stream, provides a better overall result for the client. This is because the sooner a client can take advantage of the nil tax on pension asset earnings, the greater the savings.

Table 1

Pre-retirement	Scenario 1: Death benefit income stream	Scenario 2: Proceeds held outside of super
Commencement amount	$1.6 million	$1.6 million
Drawdown	4% (minimum pension payment, $64,000 first year)	An amount that would provide the same cashflow net of tax as scenario 1. For example, $86,160 in first year to equal $64,000 pension payment.
Earnings (net of fees but before tax)	6%	6%
Balance at age 65 (future value)	$2,797,616	$1,331,798
Elaine's accumulated superannuation at age 65	$1,255,306	$1,255,306

Another way to look at the results of this case study is that the cumulative effect of the tax concessions on a death benefit income stream makes taking insurance inside super a significant advantage over taking insurance outside of super. However, this strategy would only be available to dependant beneficiaries who are capable of commencing a death benefit income stream.

Tip: If deceased and spouse are both under age 60, take lump sum commutations for amounts exceeding the minimum wherever possible.

From 1 July 2017, an income stream commenced as a result of the death of a member will always retain its characteristics as a death benefit income stream.

Furthermore, lump sum commutations from a death benefit income stream will always be treated as a lump sum death benefit payment for tax purposes. As lump sum death benefits paid to someone who is a dependant of the deceased at the time of death are not subject to tax, commutations from a death benefit income stream are also tax-free.

In contrast, pension payments are taxed at the beneficiary's marginal tax rate less a 15 per cent tax offset, if the beneficiary and the deceased were both under 60 years of age.

Clients who are under age 60 should ensure any pension payment paid from a death benefit income stream is limited to the minimum. Any additional amount should be taken as a lump sum, so it can be taxed as a lump sum death benefit payment which is tax-free.

This strategy could result in less tax payable on payments from a death benefit income stream for clients where the insured person and their beneficiary are both under age 60.

The TBC effectively restricts the amount of super ... that can be received as a death benefit income stream to $1.6 million and any excess must be cashed out of the super system.

Taking payments as commutations rather than pension payments also has TBC benefits. For TBC purposes, lump sum commutations are treated as a 'debit' event for the beneficiary's transfer balance account, whereas pension payments are not. Therefore, taking payments as lump sum commutations will 'free-up' the beneficiary's TBC that has already been used.

CASE STUDY

Kevin passed away in August 2017, aged 45. At the time of death, he had superannuation benefits of $200,000 (100 per cent taxable component) and life insurance inside superannuation of $600,000. Kevin made a binding death nomination for his spouse, Hilda, 43 years of age, to receive 100 per cent of his super benefits, including insurance. Kevin is also survived by two minor children.

Hilda is on a salary of $90,000 per annum and wants to generate an additional pre-tax income of $60,000 per annum. She decides to take the entire $800,000 from Kevin's super as a death benefit income stream.

Table 3 compares taking the $60,000 as a pension payment vs splitting the payment between minimum pension payments of $32,000 and lump sum commutations of $28,000. Hilda could save tax of $6,720 per annum if she splits the $60,000 payment. (Refer to Table 3.)

Furthermore, for TBC purposes, when Hilda commences the death benefit income stream, $800,000 will be credited to her transfer balance account. By taking the amount above the minimum as a commutation,

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Table 2

Retirement	Scenario 1: Death benefit income stream	Scenario 2: Proceeds held outside of super
TBC available	Nil	$3,800,000 (indexed at 3% pa)
ABP at age 65	$2,898,179	$2,619,829
Accumulation phase balance at age 65	$1,255,306	Nil
Pension drawdown	Lower of minimum pension payment or $121,363 (equivalent to $50,000 in today's dollars) indexed at 3% pa	Lower of minimum pension payment or $121,363 (equivalent to $50,000 in today's dollars) indexed at 3% pa
Gross earnings (net of fees)	6% pa	6% pa
ABP at age 90	$2,384,031	$1,875,553
Accumulation phase at age 90	$4,274,012	Nil
Total (future dollars)	$6,658,043	$1,875,553
Value in today's dollars (discount rate of 3% pa)	$1,310,084	$369,047

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QUESTIONS

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1 Which of the following correctly describes how proceeds from a life insurance policy held in superannuation must be cashed on death to the surviving spouse of a member?

a. A reversionary transition to retirement income stream, where the beneficiary has not met a condition of release.
b. A lump sum, retirement phase income stream or a combination of both.
c. A lump sum only.
d. A retirement phase income stream only.

2 Assuming the beneficiary's transfer balance account is zero, which of the following correctly describes the maximum amount of superannuation benefits that can be used to commence a death benefit retirement phase income stream?

a. $1.6 million.
b. Nil.
c. $1 million.
d. $800,000.

3 Joan is age 50 and commences a $1.6 million death benefit retirement phase income stream in June 2018. What is the value of Joan's personal transfer balance cap in 2028?

a. $1.6 million.
b. $1.85 million.
c. Nil.
d. $1 million.

4 The main reasons a death benefit income stream produces a better result than cashing the death benefit and investing outside super are:

a. Earnings are taxed at their marginal tax rate.
b. Earnings are taxed at the top marginal tax rate.
c. Earnings are tax-exempt in retirement phase and beneficiaries are entitled to a 15 per cent tax offset on the taxable portion of the drawdowns from a death benefit income stream (or drawdowns are tax-free if either the deceased or the beneficiary are age 60 or over).
d. None of the above.

5 Which of the following correctly describes the advantages of taking lump sum commutations from a death benefit income stream if more than the minimum is required and the clients are under age 60?

a. Commutations are tax-free, whereas pension payments are taxed at the client's marginal tax rate less a 15 per cent tax offset. Also, lump sum commutations are transfer balance debits that 'free up' cap space.
b. Commutations are taxed at the marginal tax rate less a 15 per cent tax offset.
c. Lump sum commutations are transfer balance credits, which 'use up' TBC space.
d. None of the above.

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Hilda will be freeing-up some of her TBC, as every subsequent lump sum commutation is treated as a 'debit' event for TBC purposes. This could allow Hilda to convert more of her accumulation super savings into tax-exempt retirement phase when she retires.

It is important to note that this strategy of drawing down amounts as lump sum commutations, as opposed to pension payments from death benefit income streams, can also apply to death benefit income streams commenced prior to 1 July 2017. Advisers should review all clients who are under age 60 with death benefit income streams to see if any adjustment needs to be made.

Clients should also consider the tax consequences of this strategy, including the application of any potential anti-tax avoidance provisions, where the sole or dominant purpose of entering into a transaction is to gain a tax benefit.

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Table 3

	100% pension payment	Split between pension and commutation
Pension payment	$60,000	$32,000
Commutation (taxed as lump sum death benefit)		$28,000
Tax	$14,400	$7,680
Payment net of tax	**$45,600**	**$52,320**